Supreme Court, U.S.
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# In the Supreme Court of the United States

OCTOBER TERM, 1994

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BRUCE BABBITT, SECRETARY OF THE INTERIOR, ET AL., PETITIONERS

*v.*

PHILLIPS PETROLEUM COMPANY AND ATLANTIC RICHFIELD COMPANY

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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## QUESTION PRESENTED

Whether the Department of the Interior is precluded from enforcing its determination that respondents failed to comply with regulations requiring payment of royalties on the "fair market value" of natural gas they produced from federal lands, because an internal memorandum prepared by officials of the Department's Minerals Management Service for use in assessing market value under particular circumstances was not promulgated in accordance with the notice-and-comment provisions of the Administrative Procedure Act.

## PARTIES TO THE PROCEEDING

Petitioners are the Secretary of the Interior, the Department of the Interior, the Department's Minerals Management Service (MMS), Cynthia Quarterman, Acting Director of the MMS, and Gary Johnson, Area Manager of the MMS's Dallas Area Compliance Office. Petitioners (or their predecessors in office) were defendants in the district court and appellees in the court of appeals. Both respondents were plaintiffs in the district court and appellants in the court of appeals.

## TABLE OF CONTENTS


| | Page |
|---|---|
| Opinions below | 1 |
| Jurisdiction | 2 |
| Statutory and regulatory provisions involved | 2 |
| Statement | 4 |
| Reasons for granting the petition | 14 |
| Conclusion | 28 |
| Appendix A | 1a |
| Appendix B | 12a |
| Appendix C | 15a |
| Appendix D | 18a |
| Appendix E | 71a |
| Appendix F | 98a |
| Appendix G | 122a |
| Appendix H | 124a |
| Appendix I | 128a |


## TABLE OF AUTHORITIES

Cases:


| | |
|---|---|
| *Air Transport Ass'n* v. *Department of Transportation*, 933 F.2d 1043 (D.C. Cir. 1991) | 25 |
| *Alcaraz* v. *Block*, 746 F.2d 593 (9th Cir. 1984) | 24 |
| *American Hospital Ass'n* v. *Bowen*, 834 F.2d 1037 (D.C. Cir. 1987) | 24 |
| *American Mining Congress* v. *Mine Safety & Health Admin.*, 995 F.2d 1106 (D.C. Cir. 1993) | 18, 25 |
| *American Transfer & Storage Co.* v. *ICC*, 719 F.2d 1283 (5th Cir. 1983) | 25-26 |
| *American Trucking Ass'n* v. *United States*, 688 F.2d 1337 (11th Cir. 1982), rev'd *sub nom. ICC* v. *American Trucking Ass'ns*, 467 U.S. 354 (1984) | 25 |

Cases—Continued: Page

*Amoco Production Co.*, 112 IBLA 77 (1989) ..... 19, 21
*Brown Express, Inc.* v. *United States*, 607 F.2d 695 (5th Cir. 1979) ..... 11, 12, 22
*Cabais* v. *Egger*, 690 F.2d 234 (D.C. Cir. 1982) ..... 24
*Cities Service Oil & Gas Corp.*, 113 IBLA 255 (1990) ..... 7
*Coastal States Energy Co.*, 110 IBLA 179 (1989) .. 16
*Conoco, Inc.*, 113 IBLA 243 (1990) ..... 16
*Department of Transportation* v. *Air Transport Ass'n*, cert. granted, 498 U.S. 1023, vacated and remanded, 498 U.S. 1077, dismissed as moot, 933 F.2d 1043 (D.C. Cir. 1991) ..... 15, 25
*Energy Reserves Group, Inc.* v. *Department of Energy*, 589 F.2d 1082 (Temp. Emer. Ct. App. 1978) ..... 25
*Friedrich* v. *Secretary of HHS*, 894 F.2d 829 (6th Cir.), cert. denied, 498 U.S. 817 (1990) ..... 24
*Gibson Wine Co.* v. *Snyder*, 194 F.2d 329 (D.C. Cir. 1952) ..... 18
*Guernsey Memorial Hospital* v. *Secretary of HHS*, 996 F.2d 830 (6th Cir. 1993), cert. granted, 114 S. Ct. 1395 (1994) ..... 18-19
*JEM Broadcasting Co.* v. *FCC*, 22 F.3d 320 (D.C. Cir. 1994) ..... 25
*Jean* v. *Nelson*, 711 F.2d 1455 (1983), modified on reh'g, 727 F.2d 957 (11th Cir. 1984) (en banc), aff'd, 472 U.S. 846 (1985) ..... 25
*Levesque* v. *Block*, 723 F.2d 175 (1st Cir. 1983) .... 25
*Lewis-Mota* v. *Secretary of Labor*, 469 F.2d 478 (2d Cir. 1972) ..... 24
*Lincoln* v. *Vigil*, 113 S. Ct. 2024 (1993) ..... 17, 20, 27
*Martin v. Occupational Safety & Health Review Comm'n*, 499 U.S. 144 (1991) ..... 17
*Mesa Operating Ltd. Partnership* v. *U.S. Dep't of Interior*, 931 F.2d 318 (5th Cir. 1991), cert. denied, 112 S. Ct. 934 (1992) ..... 11
*Metropolitan School Dist.* v. *Davila*, 969 F.2d 485 (7th Cir. 1992), cert. denied, 113 S. Ct. 1360 (1993) ..... 24
*NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267 (1974) .. 27

Cases—Continued: Page

*Pacific Gas & Elec. Co.* v. *Federal Power Comm'n*, 506 F.2d 33 (D.C. Cir. 1974) ..... 20
*Philadelphia Citizens in Action* v. *Schweiker*, 669 F.2d 877 (3d Cir. 1982) ..... 23, 24
*Phillips Petroleum Co.*, 117 IBLA 255 (1991) ....16, 19, 21
*Pickus* v. *United States Bd. of Parole*, 507 F.2d 1107 (D.C. Cir. 1974) ..... 24
*Public Citizen, Inc.* v. *U.S. Nuclear Regulatory Comm'n*, 940 F.2d 679 (D.C. Cir. 1991) ..... 20
*Reynolds Metals Co.* v. *Rumsfeld*, 564 F.2d 663 (4th Cir. 1977), cert. denied, 435 U.S. 995 (1978) ..... 24
*Rivera* v. *Becerra*, 714 F.2d 887 (9th Cir. 1983), cert. denied, 465 U.S. 1099 (1984) ..... 23-24
*SEC* v. *Chenery Corp.*, 332 U.S. 194 (1947) ..... 27
*Southern California Edison Co.* v. *FERC*, 770 F.2d 779 (9th Cir. 1985) ..... 24
*State of Ohio Dep't of Human Services* v. *United States Dep't of HHS*, 862 F.2d 1228 (6th Cir. 1988) ..... 24
*United States Dep't of Labor* v. *Kast Metals Corp.*, 744 F.2d 1145 (5th Cir. 1984) ..... 26
*Vermont Yankee Nuclear Power Corp.* v. *Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978) ..... 23
*Vitarelli* v. *Seaton*, 359 U.S. 535 (1959) ..... 16

Statutes and regulations:

Administrative Procedure Act, 5 U.S.C. 551 *et seq.*:
5 U.S.C. 551(4) ..... 15, 21
5 U.S.C. 552(a)(1)(D) ..... 16
5 U.S.C. 552(a)(2)(B) ..... 16
5 U.S.C. 552(a)(2)(C) ..... 16
5 U.S.C. 553(b) ..... 2, 8-9, 14
5 U.S.C. 553(b)(A) ..... 2, 13, 17, 21
Federal Oil and Gas Royalty Management Act of 1982, Pub. L. No. 97-451, 96 Stat. 2447 (1983), 30 U.S.C. 1701 *et seq.*:
§ 2(a)(2), 96 Stat. 2448, 30 U.S.C. 1701(a)(2) ..... 5

Statutes and regulations—Continued: Page

§ 2(b)(2)-(3), 96 Stat. 2448, 30 U.S.C. 1701(b)(2)-(3) ..... 5
§ 101(a), 96 Stat. 2449-2450, 30 U.S.C. 1711(a) ..... 5
§ 101(c)(1), 96 Stat. 2450, 30 U.S.C. 1711(c)(1) ..... 5, 26
Outer Continental Shelf Lands Act, ch. 345, 67 Stat. 462 (1953), 43 U.S.C. 1331 *et seq.* ..... 4
§ 8(a)(1), 67 Stat. 468, 43 U.S.C. 1337(a)(1) .. 2, 3, 4
28 U.S.C. 2415(a) ..... 10
30 C.F.R.:
Pt. 206:
Section 206.102 ..... 4
Section 206.150 (1987) ..... 3, 4, 13, 18, 19
Section 206.150(e) (1987) ..... 3
Pt. 217 (1987):
Section 217.50 ..... 7
Pt. 218 (1987) ..... 6
Section 218.150 ..... 6, 7
Pt. 241 (1987):
Section 241.51 ..... 6
Pt. 290 (1987):
Sections 290.1-290.5 ..... 6
Section 290.7 ..... 6
43 C.F.R. (1987):
Section 4.1 ..... 6, 16
Section 4.1(b)(3) ..... 6, 16

Miscellaneous:

K. Davis, *Administrative Law of the Eighties* (1989) ..... 24
2 K. Davis, *Administrative Law Treatise* (2d ed. 1979) ..... 24
K. Davis, *Administrative Law Treatise* (Supp. 1982) ..... 26

Miscellaneous—Continued: Page

1 K. Davis & R. Pierce, Jr., *Administrative Law Treatise* (3d ed. 1994) ..... 27
53 Fed. Reg. 1230 (1988) ..... 4
Note, *The Substantial Impact Test: Victim of the Fallout from Vermont Yankee?*, 53 Geo. Wash. L. Rev. 118 (1985) ..... 24
U.S. Dep't of Justice, *Attorney General's Manual on the Administrative Procedure Act* (1947) ..... 18, 20

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The Solicitor General, on behalf of the Secretary of the Interior, the Department of the Interior, the Department's Minerals Management Service (MMS), Cynthia Quarterman, Acting Director of the MMS, and Gary Johnson, Area Manager of the MMS's Dallas Area Compliance Office, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

### OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-11a) is reported at 22 F.3d 616. That court's supplemental opinion on rehearing concerning the statute of limitations issue (App., *infra*, 124a-127a) is unreported, as are the opinion, orders, and judg-

ment of the district court (App., *infra*, 12a-70a). The opinion of the Interior Board of Land Appeals affirming one of the MMS orders at issue in this case (App., *infra*, 98a-121a) is reported at 110 IBLA 232. The remaining MMS orders at issue (App., *infra*, 71a-97a) are unreported.

## JURISDICTION

The court of appeals entered its initial judgment on June 10, 1994. The court thereafter granted rehearing and entered a new judgment addressing a previously unresolved issue (but otherwise abiding by the prior opinion) on September 7, 1994. App., *infra*, 124a-127a. A further petition for rehearing was denied on November 1, 1994. App., *infra*, 122a-123a. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## STATUTORY AND REGULATORY PROVISIONS INVOLVED

1. Section 553(b) of Title 5 of the United States Code (formerly Section 4(a) of the Administrative Procedure Act) provides in pertinent part as follows:

> (b) General notice of proposed rule making shall be published in the Federal Register * * *
>
> * * * * *
>
> Except when notice or hearing is required by statute, this subsection does not apply—
>
> > (A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice.
>
> * * * * *

2. Section 8(a)(1) of the Outer Continental Shelf Lands Act, ch. 345, 67 Stat. 468 (1953), as amended,

codified at 43 U.S.C. 1337(a)(1), provides in part as follows:

> The Secretary is authorized to grant to the highest responsible qualified bidder or bidders by competitive bidding, under regulations promulgated in advance, any oil and gas lease on submerged lands of the outer Continental Shelf * * *. The bidding shall be by sealed bid and, at the discretion of the Secretary, on the basis of—
>
> (A) cash bonus bid with a royalty at not less than 12½ per centum fixed by the Secretary in amount or value of the production saved, removed, or sold;
>
> (B) variable royalty bid based on a per centum in amount or value of the production saved, removed, or sold, with either a fixed work commitment based on dollar amount for exploration or a fixed cash bonus as determined by the Secretary, or both;
>
> [Paragraphs (C) through (H) similarly describe possible alternative bidding mechanisms.]

3. During the period relevant to this case, 30 C.F.R. 206.150 (1987) provided as follows:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value

> of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

## STATEMENT

1. Congress has authorized the Department of the Interior to enter into and administer leases providing for the development of federal oil and gas resources, including those located off the coast of the United States. See, *e.g.*, 43 U.S.C. 1331 *et seq.* (the Outer Continental Shelf Lands Act). Leases for development of offshore oil and gas are generally to be granted to "the highest responsible qualified bidder" after a public, competitive bidding process, and generally provide for payment of royalties calculated as a specified percentage of the "amount or value of the production saved, removed, or sold" by the lessee. 43 U.S.C. 1337(a)(1).

The Secretary's regulations applicable to the valuation of offshore oil and gas production for royalty purposes for the periods of production at issue in this case provide that value will be determined by the Director of the Minerals Management Service (MMS) in the Department of the Interior, and will "never be less than the fair market value." 30 C.F.R. 206.150 (1987).[1] Section 206.150 provides further that in establishing values,

> the Director shall consider: (a) The highest price paid for a part or for a majority of like-

[1] The regulation was substantially expanded and redesignated as of March 1, 1988. See 30 C.F.R. 206.102; 53 Fed. Reg. 1230 (1988).

> quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

In 1983, Congress concluded that the government's methods of determining and collecting oil and gas lease royalties were "archaic and inadequate." Federal Oil and Gas Royalty Management Act of 1982, Pub. L. No. 97-451, § 2(a)(2), 96 Stat. 2448 (1983), codified at 30 U.S.C. 1701(a)(2). Congress therefore acted "to clarify, reaffirm, expand and define the authorities and responsibilities of the Secretary of the Interior to implement and maintain a royalty management system for oil and gas leases," and "to require the development of enforcement practices that ensure the prompt and proper collection and disbursement of oil and gas revenues owed to the United States." 30 U.S.C. 1701(b)(2)-(3). The 1983 Act directs the Secretary to establish "a comprehensive inspection, collection and fiscal and production accounting and auditing system * * * to accurately determine oil and gas royalties * * * and to collect and account for such amounts in a timely manner." 30 U.S.C. 1711(a). In particular, the Act directs the Secretary to "audit and reconcile, to the extent practicable, all current and past lease accounts for leases of oil or gas and [to] take appropriate actions to make additional collections or refunds as warranted." 30 U.S.C. 1711(c)(1).

The Secretary has delegated responsibility for administering lease arrangements and enforcing royalty requirements to the Director of the Minerals Management Service. See generally 30 C.F.R. Pt. 218 (1987); 30 C.F.R. 218.150, 241.51 (1987). Lessees may appeal the orders or decisions of subordinate MMS officials to the Director. See 30 C.F.R. 290.1-290.5 (1987). The Director's decisions, in turn, are subject to review by the Interior Board of Land Appeals (IBLA), which issues final agency decisions on such issues on behalf of the Secretary. See 30 C.F.R. 290.7 (1987); 43 C.F.R. 4.1, 4.1(b)(3) (1987).

2. In 1984, investigations by MMS's Royalty Compliance Division and the Department's Inspector General raised questions about the appropriate method of valuing natural gas liquid products (NGLPs) for purposes of calculating the production royalties due under federal leases.[2] See App., *infra*, 130a. The valuation problem was particularly acute in cases in which NGLPs produced under such leases were not sold in arm's-length transactions, but rather were transferred to affiliates of the lessee. *Ibid.* The Compliance Division and MMS's Royalty Valuation and Standards Division thereafter examined the issue and collaborated in producing a "Procedure Paper on Natural Gas Liquid Products Valuation," reprinted at App., *infra*, 128a-146a.

The "procedure paper" noted that "MMS regulations require the Secretary to establish a basis for computing royalties using a reasonable unit value," and that the value so established "should never be less than the fair market value as determined by guide-

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[2] NGLPs are heavier entrained liquid hydrocarbons contained in "wet" natural gas. See App., *infra*, 4a n.1.

lines established by the Secretary." App., *infra*, 130a. As a practical matter, however, lessees track and report their own production, its value, and the royalties due thereon, subject to audit by MMS's Royalty Compliance Division. See generally, *e.g.*, 30 C.F.R. 217.50, 218.150 (1987); see also *Cities Service Oil & Gas Corp.*, 113 IBLA 255, 260 (1990). The paper's purpose was therefore "to develop a 'yardstick' valuation technique" for MMS auditors to use in "determining the reasonableness of a lessee's NGLP prices" for royalty purposes. App., *infra*, 130a.

The procedure paper identified two types of NGLP sales: sales under arm's-length contracts, and those in which NGLPs were transferred without a contract or under a non-arm's-length agreement, such as one between divisions or affiliates of the lessee. See App., *infra*, 131a-132a. With respect to arm's-length sales, the paper stated that "MMS will normally accept the arm's-length contract price for royalty purposes." *Id.* at 135a-136a. With respect to non-arm's-length sales, however, the paper concluded that MMS would accept royalties computed using the contract price only if "the lessee can demonstrate that the contract has characteristics similar to arm's-length contracts which represent fair market value." *Id.* at 136a.

To establish an appropriate "market value" standard against which to measure NGLP prices reported by lessees, the authors of the procedure paper considered several possible price sources: NGLP sales contracts, prices received by lessees, "maximum permissible prices" under Department of Energy price regulations in effect during part of the period in question, and commercially available NGLP price bulletins. See App., *infra*, 132a. The paper concluded that "commercial price bulletins represent the

best available price source and in most instances are indicative of NGLP fair market value." *Ibid.* The paper then specified an order of preference among particular bulletins available for particular periods. *Id.* at 133a.

Having selected an appropriate market value "yardstick," the procedure paper concluded that prices reported by a lessee for royalty purposes should be compared to the highest and lowest prices for the same product published in the appropriate bulletin for the appropriate month. App., *infra*, 133a. A reported price falling within the range of published prices "[would] normally be accepted by MMS for royalty determination purposes." *Ibid.* Where the reported price fell below the lowest published price, however, "a minimum value that is acceptable to MMS [could] be determined by developing an average value from the lowest and highest prices in the range" of published prices. *Id.* at 134a; see also *id.* at 136a.

3. a. In 1986, the Regional Manager of MMS's Tulsa, Oklahoma compliance office ordered a lessee affiliate of respondent Atlantic Richfield Company (ARCO) to pay additional royalties, calculated in accordance with the procedure paper's methodology, on certain NGLPs that ARCO had produced from federal lands and had used internally rather than sold. See App., *infra*, 101a, 103a. ARCO appealed that order to the Director of MMS, who affirmed it. *Id.* at 100a-101a, 105a-107a.

ARCO then appealed to the Interior Board of Land Appeals. The Board rejected the argument that the MMS "procedure paper" was a "substantive rule" subject to the notice-and-comment provisions of the Administrative Procedure Act (APA), 5 U.S.C.

553(b). App., *infra*, 117a-118a. The Board noted that the procedure paper "did not require lessees to value their production by any specific method, nor did it modify any existing regulation"; rather, it "merely clarified the existing regulations by setting forth a yardstick by which MMS would measure the reasonableness of royalty values reported by lessees." *Id.* at 117a. The Board characterized the paper as "essentially a policy guideline adopted by MMS to assist in valuing NGLP production for royalty purposes under the provisions of the relevant regulation." *Ibid.* The Board therefore concluded that the procedure paper "does not have the force and effect of law as a duly promulgated regulation does," and made clear that the Board would decline to follow the paper's methods where it considered them inconsistent with the relevant regulations. *Id.* at 117a-118a.

On the merits, the Board sustained MMS's comparative use of spot market prices quoted in commercial bulletins to evaluate the reasonableness of ARCO's royalty valuations under the governing regulation. See App., *infra*, 112a-117a. The Board rejected, however, the procedure paper's approach of using the average spot market price to recompute the value of production if the lessee's reported price was less than the lowest spot market price. *Id.* at 119a-120a. The Board found it inconsistent to require use of the average spot price in cases in which a lower (but within-range) price would have been accepted as representing "fair market value." The Board therefore set aside the MMS orders and remanded for recomputation of additional royalties using the lowest published spot market price, rather than the average price, in cases in which the price reported by the

lessee was lower than the lowest published price. *Id.* at 120a.

b. Shortly after the Board's decision on ARCO's appeal, MMS issued three additional royalty compliance orders to ARCO and one to respondent Phillips Petroleum Company (Phillips), based on audits showing that respondents had underpaid royalties between 1980 and 1988 on NGLPs used or disposed of in non-arm's-length transactions. See App., *infra*, 71a-97a. The orders directed respondents to recompute those royalties using the methodology outlined in the procedure paper, as modified by the IBLA's decision. Each respondent filed suit to block enforcement of the orders, arguing in part that some or all of the additional royalty claims were barred by the statute of limitations set out in 28 U.S.C. 2415(a) for government suits for money damages; that the Secretary had no authority to require respondents to review their own records and recompute royalties under a government methodology; and that the Secretary could not apply that methodology in any event, because the procedure paper in which it was first articulated constituted a substantive rule adopted without compliance with the notice-and-comment provisions of the APA. ARCO later amended its complaint to add a challenge to the order previously upheld by the IBLA. Respondents' suits were consolidated with each other, and with two others in which they raised similar statute-of-limitations and "self-audit" issues in the context of a different royalty dispute.[3]

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[3] The non-NGLP cases challenged MMS orders requiring computation and payment of royalties on certain amounts

The district court granted summary judgment in favor of the Secretary. App., *infra*, 18a-70a. After an extensive review of the MMS procedure paper, the court rejected respondents' APA challenge to the use of the paper's methodology as modified by the IBLA. *Id.* at 48a-63a. The court concluded that the procedure paper represented, "in substance and application," an interpretation and application of the existing regulatory requirement that royalties be paid on the "fair market value" of production. *Id.* at 58a-60a, 63a.

Alternatively, the court considered the paper as a "procedural rule" under the APA (App., *infra*, 60a-62a), and applied the "substantial impact" test articulated by the Fifth Circuit in *Brown Express, Inc.* v. *United States*, 607 F.2d 695, 702 (1979) (emphasis omitted):

> [W]hen a proposed regulation of general applicability has a substantial impact on the regulated industry, or an important class of the members or the products of that industry, notice and opportunity for comment should first be provided.

Because the paper merely implemented the preexisting "fair market value" requirement of the regulations, the court determined that "the paper, itself, is not the source of any substantial impact on the

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received from purchasers as reimbursement for production-related costs. That issue was resolved in favor of the government in other litigation, see *Mesa Operating Ltd. Partnership* v. *U.S. Dep't of Interior*, 931 F.2d 318 (5th Cir. 1991), cert. denied, 112 S. Ct. 934 (1992), leaving only the limitations and "self-audit" challenges to those orders to be resolved in this proceeding.

[offshore] leasing industry and [offshore] lessees," and therefore qualified for the statutory exemption. *Id.* at 63a.

On the other issues before it, the district court held that the Secretary could require respondents to recompute royalties due (App., *infra*, 41a-45a), and that the statute of limitations "bars the Government from bringing any causes of action against Phillips and ARCO based on royalty payments * * * that are due and owing for more than six years" (*id.* at 40a-41a). The court subsequently clarified, however, that the Secretary's request for enforcement of the royalty orders at issue in this case was not such an action. *Id.* at 15a-17a. Having rejected respondents' APA and "self-audit" objections to those orders, the court ordered respondents to comply with them by recomputing and paying royalties in accordance with their terms. *Id.* at 12a-14a.

4. The court of appeals reversed, holding that the MMS procedure paper was a substantive rule that should have been promulgated in accordance with the APA's notice-and-comment procedures. App., *infra*, 1a-11a.

Relying on its prior decision in *Brown Express, Inc.* v. *United States*, *supra*, the court rejected (App., *infra*, 7a-8a) the Secretary's argument that the procedure paper was nothing more than a "clarification or explanation" of the existing royalty valuation regulation in the specific context of NGLPs not sold in arm's-length transactions. In the court's view, the paper could not be characterized as an exempt "interpretative rule" because it "does not purport to interpret a statute or regulation," "is not a mere clarification," "defines no ambiguous term," and "gives no

officer's opinion about the meaning of the statute or regulations," but rather "effects a change in the method used by MMS in valuing NGLPs." *Id.* at 8a. Similarly, the court rejected the argument that the paper could be viewed as a "general statemen[t] of policy," see 5 U.S.C. 553(b)(A), because, under the court's analysis, "[i]mmediately upon [the paper's] effective date, the five-factor valuation technique of 30 C.F.R. § 206.150 was no longer to be followed" in valuing NGLPs for royalty purposes. App., *infra*, 9a.

Finally, the court of appeals held that the procedure paper was not exempt from the notice-and-comment requirement as a "rul[e] of agency organization, procedure, or practice." App., *infra*, 9a; see 5 U.S.C. 553(b)(A). The court observed that the paper "would appear to fall squarely within this exemption," because it "plainly relates to the internal practices of MMS." App., *infra*, 9a. But the court went on to apply the *Brown Express* "substantial impact" test, quoted above. *Id.* at 10a. Unlike the district court, the court of appeals concluded (*id.* at 10a-11a) that "the Procedure Paper does have a substantial impact on those regulated in the industry" because, in the court of appeals' view, it "narrowly restricts the discretion of MMS officials" in valuing NGLPs, "forecloses other valuation methods by prescribing binding valuation criteria," "mandates the use of *spot* prices" rather than the "*posted* prices" referred to in 30 C.F.R. 206.150 (1987), and "eliminates the other four factors" listed in the regulation for purposes of determining the value of NGLPs. The court therefore refused to give effect to the statutory exception for "rules of agency * * * practice" that it thought otherwise "plainly" applicable in this case.

In light of its ruling on the APA issue, the court of appeals reversed the judgment of the district court and remanded for further proceedings, without reaching any of the other issues presented by the parties. App., *infra*, 11a. Both parties sought rehearing on the statute of limitations question, and the court issued a brief supplementary opinion resolving that issue in favor of the Secretary. *Id.* at 124a-127a. The same order denied the Secretary's suggestion of rehearing en banc on the APA issues, and a later order (*id.* at 122a-123a) denied respondent Phillips's further petition for rehearing and suggestion of rehearing en banc on the limitations issue.

## REASONS FOR GRANTING THE PETITION

The court of appeals has precluded the Secretary from enforcing orders requiring the proper computation and payment of royalties on NGLPs produced from federal lands. It reached that result solely because an internal "procedure paper," prepared and used by agency compliance officers in assessing whether royalties remitted by federal lessees complied with applicable valuation regulations, was not itself promulgated in accordance with the formal notice-and-comment procedure of the Administrative Procedure Act, 5 U.S.C. 553(b). That decision is wrong, and has broad and potentially serious implications for the efficient functioning of the administrative process.

Moreover, the court's decision turned in significant part on its application of a "substantial impact" test that is inconsistent with the terms of the APA itself and has been rejected by other courts of appeals. This Court previously granted review to resolve a

circuit conflict regarding use of that test, but the case later became moot. See *Department of Transportation* v. *Air Transport Ass'n*, 498 U.S. 1023, vacated and remanded, 498 U.S. 1077, dismissed as moot, 933 F.2d 1043 (D.C. Cir. 1991). This case presents an appropriate occasion to settle a recurrent issue of considerable importance under the APA.

1. The court of appeals held that the MMS "procedure paper" at issue in this case is a "substantive rule." App., *infra*, 11a. At the threshold, there is a substantial question whether the paper fits the APA's definition of a "rule" at all. Under the statute, a "rule" is

> the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes the approval or prescription for the future of * * * valuations, costs, or accounting, or practices bearing on any of the foregoing.

5 U.S.C. 551(4). That definition is broad, but it is not unlimited.

While the procedure paper might, for example, be characterized as a "statement of general * * * applicability * * * designed to implement * * * [or] interpret * * * law or policy * * * or [to] prescri[be] * * * practices bearing on" "valuation," we doubt that it can properly be described as an "*agency* statement." The paper was compiled by subordinate officials in MMS, and it did not purport to bind even the Director of that Service, to whom any party aggrieved by an order applying the paper's methodology would

appeal in the first instance. Compare 5 U.S.C. 552(a)(2)(C) (referring to "administrative staff manuals and instructions to staff") with 5 U.S.C. 552(a)(1)(D) and (2)(B) (referring to rules and statements "adopted by the agency"). More important, the paper clearly did not speak for or bind the Secretary, because the IBLA, as the Secretary's delegate, rejected a portion of the paper's methodology that it found unreasonable.[4] App., *infra*, 119a-120a. Put differently, the *paper's* interpretation and application of the regulation's "fair market value" requirement did not become the *Secretary's* interpretation and application until the IBLA issued final agency orders that directed particular lessees to recompute their royalties using the IBLA's modified version of the methodology set out in the paper. Thus, the "agency statement" that the court of appeals purported to strike down was one that the Secretary (through the IBLA) had explicitly refused to adopt or apply in full accordance with its terms.

The purpose of the procedure paper was to set forth a general "yardstick" to guide agency enforcement personnel in evaluating lessees' compliance with the "fair market value" rule of the governing regulation.

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[4] The IBLA renders final decisions for the Department under authority delegated directly by the Secretary. See 43 C.F.R. 4.1, 4.1(b)(3) (1987). The Board, like the Secretary himself, is bound by properly adopted substantive regulations. See, *e.g.*, *Vitarelli* v. *Seaton*, 359 U.S. 535, 539-540 (1959); *Conoco, Inc.*, 113 IBLA 243, 249 (1990); *Coastal States Energy Co.*, 110 IBLA 179 (1989). The Board would therefore have been bound by the procedure paper, in its entirety, if it were a substantive rule. See also, *e.g.*, *Phillips Petroleum Co.*, 117 IBLA 255, 261, 262 (1991) (Board not bound by "internal agency interpretative pronouncements such as the Procedure Paper").

App., *infra*, 130a. The problem that the paper addresses first became apparent in the course of attempts to determine whether existing lessees had been complying with existing rules, see *ibid.*; and the solution that the valuation and compliance personnel agreed upon was applied, as it was always intended to be applied, to audit past transactions for purposes of determining whether to issue initial orders to lessees to pay additional royalties with respect to past production. Thus, the valuation and compliance divisions' joint memorandum is perhaps best viewed as an initial step in the process of enforcing existing rules as applied to past or ongoing conduct—that is, as a guide to the commencement of one or more adjudications. See *Martin* v. *Occupational Safety & Health Review Comm'n*, 499 U.S. 144, 157 (1991). Viewed in that light, the court of appeals' decision in this case prevents enforcement of final agency orders on the ground that an initial enforcement policy memorandum, prepared by and for the use of agency compliance personnel at the beginning of the adjudication process, was not issued for public notice and comment. That result represents a profound —and profoundly disruptive—misreading of the APA.

2. Even assuming that the MMS procedure paper is properly characterized as an agency "rule," the court erred in requiring notice-and-comment procedures for its adoption. See *Lincoln* v. *Vigil*, 113 S. Ct. 2024, 2034 (1993). The APA exempts from those procedures "interpretative rules, general statements of policy, [and] rules of agency organization, procedure, or practice." 5 U.S.C. 553(b)(A). The document at issue here is far more plausibly placed within one of those categories than within the quite distinct category of "substantive" rules.

a. *Interpretative Rule.* Any fair reading of the procedure paper indicates that it was created not to alter the "fair market value" requirement of 30 C.F.R. 206.150 (1987), but to set forth a standard method that compliance auditors could use for interpreting that requirement and applying it to particular arrangements involving non-arm's-length transfers of NGLPs. As the district court pointed out, "[f]rom beginning to end, the [paper] strives to explain what generally constitutes 'fair market value' in certain circumstances; it falls well short of effecting a change in existing law or policy." App., *infra*, 58a.

The paper identifies a practical valuation problem (App., *infra*, 130a), states the generally applicable regulatory standard (*ibid.*), and then sets out an administrative view about how that issue should be resolved under several variations of a specific factual context (*id.* at 132a-137a). The purpose and effect of the paper thus closely resemble classic definitions of what constitutes an "interpretative" rule. See, *e.g.*, *Gibson Wine Co.* v. *Snyder*, 194 F.2d 329, 331 (D.C Cir. 1952) ("statements as to what the administrative officer thinks the statute or regulation means"); U.S. Dep't of Justice, *Attorney General's Manual on the Administrative Procedure Act* 30 n.3 (1947) [hereinafter *Attorney General's Manual*] (statements embodying "the agency's construction of the statutes and rules which it administers"); see also *American Mining Congress* v. *Mine Safety & Health Admin.*, 995 F.2d 1106, 1110 (D.C. Cir. 1993) (discussing distinction between substantive and interpretive rules); cf. *Guernsey Memorial Hospital* v. *Secretary of HHS*, 996 F.2d 830, 834-836 (6th Cir. 1993) (holding, in part, that an agency manual provision is

invalid as a legislative rule issued without notice and comment), cert. granted, 114 S. Ct. 1395 (1994) (argued Oct. 31, 1994). The court of appeals' conclusory statements to the contrary—that the paper "does not purport to interpret a statute or regulation," "defines no ambiguous term," and "gives no officer's opinion about the meaning of the statute or regulations," but instead "effects a change in the method used by MMS in valuing NGLPs" (App., *infra*, 8a)—ignore the entire premise and thrust of the document.[5]

b. *General Statement of Policy.* As the court of appeals acknowledged (App., *infra*, 7a), the Interior Board of Land Appeals regarded the procedure paper not as a substantive rule but as "essentially a policy

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[5] The court described the procedure paper as "narrowly restrict[ing] the discretion of MMS officials," "foreclos[ing]" other valuation methods, "mandat[ing]" the use of one valuation method, or "eliminat[ing]" alternative regulatory valuation factors. App., *infra*, 10a-11a. But the paper notes that its authors proceeded by first studying, with respect to a particular factual context, precisely the regulatory factors to be "considered" by the Director in determining royalty value under the regulation. Compare 30 C.F.R. 206.150 (1987) (comparable sales, lessee receipts, posted prices, regulated prices, and "other relevant matters") with App., *infra*, 132a (relevant sales contracts, lessee receipts, prices prescribed by regulation, and published spot prices (the closest approximation of "posted prices" in the NGLP context)). The resulting paper does not "mandate" a particular result in all cases, but merely concludes (*ibid.*) that "in most instances" spot prices "represent the best available * * * indicati[on] of NGLP fair market value." The paper explicitly states that lessees may demonstrate fair market value by other methods. *Id.* at 136a. See also *Amoco Production Co.*, 112 IBLA 77, 85-86 (1989); *Phillips Petroleum Co.*, 117 IBLA 255, 261, 262 (1991).

guideline adopted by MMS to assist in valuing NGLP production for royalty purposes under the provisions of the relevant regulation." *Id.* at 117a. That view is consistent with the central character of the paper as a statement of *compliance division* policy, adopted by front-line agency personnel, to be implemented through enforcement efforts relating to past conduct, and subject to further consideration and review during the adjudication process before its formal adoption as *agency* policy by the Secretary or his delegates.

In applying the exception for "general statements of policy" under the APA, courts have considered whether agency statements are designed "to advise the public prospectively of the manner in which the agency proposes to exercise a discretionary power," see *Lincoln* v. *Vigil*, 113 S. Ct. at 2034 (quoting *Attorney General's Manual* 30 n.3); or, in other circumstances, whether the agency "inten[ded] to be bound" by its pronouncement, *Public Citizen, Inc.* v. *U.S. Nuclear Regulatory Comm'n*, 940 F.2d 679, 682 (D.C. Cir. 1991), or whether the statement is "finally determinative of the issues or rights to which it is addressed." *Pacific Gas & Elec. Co.* v. *Federal Power Comm'n*, 506 F.2d 33, 38 (D.C. Cir. 1974). In this case, as the IBLA made clear (App., *infra*, 117a), the procedure paper itself has never had the force or effect of law. If the IBLA enters a final order directing a lessee to pay additional royalties, it does so not because the lessee has "violated" the procedure paper, but because the lessee has violated the governing statute or its implementing regulations. Thus, even if preparation of the procedure paper is viewed as a rulemaking, the paper's ultimate impact was and remains heavily dependent on subsequent review and

application in particular adjudicatory proceedings.[6] Its provisional conclusions are therefore surely better viewed as a "general statemen[t] of policy" with respect to royalty enforcement than as a substantive or "legislative" rule.

c. *Rule of Agency Organization, Procedure, or Practice.* Finally, the notice-and-comment requirements do not apply to "rules of agency organization, procedure, or practice." 5 U.S.C. 553(b)(A). The court of appeals itself thought that the procedure paper "would appear to fall squarely within this exemption," because its provisions "plainly relat[e] to the internal practices of MMS." App., *infra*, 9a.

The precise scope of the exemption for rules of agency "practice" is unclear. On its face, it covers a broad range of agency "practices" or modes of operation. Compare 5 U.S.C. 551(4) ("rule[s]" include the "prescription * * * of * * * practices" bearing on, *inter alia*, "valuations"). The exemption could also be understood more narrowly, however, to refer only to rules governing the "practice" of attorneys or others before the agency. Compare *ibid.* ("rule[s]" include statements that "describ[e] the organization, procedure, or practice requirements of an agency"). In any event, because of the procedure paper's provisional, non-binding nature and its direct

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[6] See also, *e.g.*, *Phillips Petroleum Co.*, 117 IBLA at 262 (paper's statement "that spot market prices will 'in most instances' be indicative of the fair market value of NGLP * * * does not preclude MMS from deciding in any given case that one of the factors listed in 30 CFR 206.150 (1985) is more indicative of such value"); *Amoco Production Co.*, 112 IBLA at 85-86 (refusing to use spot market price to value certain NGLPs).

relevance to the auditing and enforcement "practices" of MMS's Royalty Compliance Division, the paper is certainly *better* characterized as a "rul[e] of agency * * * practice" than as a substantive or legislative rule. Similarly, the "procedure paper" is, as its name suggests (and as the court of appeals thought), a "rul[e] of agency * * * procedure" in the sense that it describes the manner in which MMS personnel should audit lessee accounts. The court of appeals erred in nevertheless concluding (App., *infra*, 9a) that "the mere fact that [the paper] may guide MMS procedures does not mean that the Procedure Paper is a 'procedural' rule for purposes of the APA."

3. In precluding enforcement of royalty orders based on the methodology developed in the procedure paper, the court of appeals relied heavily on its prior decision in *Brown Express, Inc.* v. *United States*, 607 F.2d 695 (1979). In particular, the court concluded that the paper's methodology effected changes in the governing regulatory valuation standards that would have a "substantial impact" on lessees under the test adopted in *Brown Express*. See App., *infra*, 7a-10a. Thus, in a strikingly candid departure from the text of the APA, the court stated that its inquiry was "not whether the rule is 'substantive' or 'procedural,' but rather whether the rule will have a 'substantial impact' on those regulated." *Id.* at 10a. Indeed, the court acknowledged (*id.* at 9a-10a) that, but for that standard, it would have held the procedure paper exempt from the APA's notice-and-comment requirements. That application of the court's own "substantial impact" test to supplement and, indeed, supplant the exemption standards explicitly provided by the

APA itself conflicts with decisions of this Court and other courts of appeals, and warrants further review.

In *Vermont Yankee Nuclear Power Corp.* v. *Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978), this Court made clear that courts are not free to alter the APA's rulemaking requirements by "engrafting their own notions of proper procedures upon agencies." *Id.* at 525. The APA prescribes a set of carefully circumscribed, minimum requirements. The courts are not free to supplement those requirements based on their own views of the need for or desirability of further public involvement, because "Congress intended that the discretion of the *agencies* and not that of the courts be exercised in determining when *extra* procedural devices should be employed." *Id.* at 546 (emphasis added in part). The courts may not, therefore, determine that the "substantial impact" of an agency action requires the use of APA procedures when the Act itself would not require that those procedures be followed.

Although the question in *Vermont Yankee* was whether a court could impose procedures in addition to the APA notice-and-comment procedure concededly applicable in that case, the Court's rationale applies with equal force where, as here, the issue is whether a court may require resort to that procedure where it would not apply under the terms of the APA. The APA includes express exceptions precisely in order to avoid the need for compliance where Congress has determined that it is not essential. See, *e.g.*, *Philadelphia Citizens in Action* v. *Schweiker*, 669 F.2d 877, 881 (3d Cir. 1982). Whatever a court may think of that determination as it applies in a particular case, "the explicit judgment of Congress as to when administrative agencies may

dispense with formal rulemaking procedures must be respected." *Ibid.*

The court of appeals' decision also conflicts with the rejection of the "substantial impact" test by other courts of appeals. Before *Vermont Yankee*, the lower courts frequently relied on some version of a "substantial impact" test in applying the APA's notice-and-comment requirements.[7] Following *Vermont Yankee*, however, the Ninth Circuit rejected the substantial impact test altogether, finding it inconsistent with the teachings of that case. See *Rivera* v. *Becerra*, 714 F.2d 887, 889-891 (1983), cert. denied, 465 U.S. 1099 (1984); *Alcaraz* v. *Block*, 746 F.2d 593, 613 (1984); *Southern California Edison Co.* v. *FERC*, 770 F.2d 779, 783 (1985). Other courts have likewise rejected or criticized the test in various contexts.[8] This Court

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[7] See, *e.g.*, *Reynolds Metals Co.* v. *Rumsfeld*, 564 F.2d 663, 669 (4th Cir. 1977), cert. denied, 435 U.S. 995 (1978); *Pickus* v. *United States Bd. of Parole*, 507 F.2d 1107, 1114 (D.C. Cir. 1974); *Lewis-Mota* v. *Secretary of Labor*, 469 F.2d 478, 482 (2d Cir. 1972). See also 2 K. Davis, *Administrative Law Treatise* §§ 7:15-7:20 (2d ed. 1979); K. Davis, *Administrative Law of the Eighties* § 7:20 (1989); Note, *The Substantial Impact Test: Victim of the Fallout from Vermont Yankee?*, 53 Geo. Wash. L. Rev. 118 (1985).

[8] See, *e.g.*, *Metropolitan School Dist.* v. *Davila*, 969 F.2d 485, 493 (7th Cir. 1992), cert. denied, 113 S. Ct. 1360 (1993); *Friedrich* v. *Secretary of HHS*, 894 F.2d 829, 836 (6th Cir.), cert. denied, 498 U.S. 817 (1990); *State of Ohio Dep't of Human Services* v. *United States Dep't of HHS*, 862 F.2d 1228, 1233-1234 (6th Cir. 1988); *Cabais* v. *Egger*, 690 F.2d 234, 237-238 (D.C. Cir. 1982) (rejecting test in distinguishing between interpretive and substantive rules); *American Hospital Ass'n* v. *Bowen*, 834 F.2d 1037, 1047 (D.C. Cir. 1987) (commenting on court's "move away" from test with respect to procedural rules, based on "candid recognition that even

granted review to resolve the circuit conflict in *Department of Transportation* v. *Air Transport Ass'n*, 498 U.S. 1023 (1991), but that case subsequently became moot. See 498 U.S. 1077 (1991) (vacating decision below and remanding for consideration of mootness); 933 F.2d 1043 (D.C. Cir. 1991) (dismissing case as moot); see also *id.* at 1043 (Silberman, J., concurring).[9]

Indeed, the Fifth Circuit itself has acknowledged that the "substantial impact" test has been "much criticized" by courts and commentators, including Professor Davis, who has stated that the court's holding in *Brown Express* "is clearly *not* the law." *American Transfer & Storage Co.* v. *ICC*, 719 F.2d 1283, 1285

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unambiguously procedural measures affect parties to some degree"); *Levesque* v. *Block*, 723 F.2d 175, 182 (1st Cir. 1983) (test "may be relevant in construing the intent of the agency in issuing [a] rule"); see also *Energy Reserves Group, Inc.* v. *Department of Energy*, 589 F.2d 1082, 1093-1098 (Temp. Emer. Ct. App. 1978) (opinion of Becker, J.) (criticizing test). A panel of the Eleventh Circuit, although viewing the decision in *Brown Express* as part of the law of that court, has criticized it as contrary to *Vermont Yankee*. See *American Trucking Ass'n* v. *United States*, 688 F.2d 1337, 1351-1352 & n.20 (1982), rev'd on other grounds *sub nom. ICC* v. *American Trucking Ass'ns*, 467 U.S. 354 (1984); *Jean* v. *Nelson*, 711 F.2d 1455, 1479-1480 & nn.18, 20 (1983), modified on other grounds on reh'g, 727 F.2d 957 (1984) (en banc), aff'd on other grounds, 472 U.S. 846 (1985).

[9] The D.C. Circuit has apparently retreated from its previous reliance on substantial impact considerations in applying the APA exemption for procedural rules. See, *e.g.*, *JEM Broadcasting Co.* v. *FCC*, 22 F.3d 320, 326-328 (1994); cf. *American Mining Congress* v. *Mine Safety & Health Admin.*, 995 F.2d at 1110 (discussing distinction between substantive and interpretive rules).

& n.4 (1983), quoting K. Davis, *Administrative Law Treatise* § 6:31 (Supp. 1982). Nonetheless, as this case demonstrates, the Fifth Circuit has continued to defend and apply the test, even in the face of *Vermont Yankee* and the contrary trend of authority in the other courts of appeals. See App., *infra*, 10a ("substantial impact" is the "proper test"); *United States Dep't of Labor* v. *Kast Metals Corp.*, 744 F.2d 1145, 1154 n.19 (5th Cir. 1984) (rejecting Ninth Circuit's analysis of *Vermont Yankee*). The issue is therefore ripe for this Court's review.

4. The issue presented by this case is of significant practical importance to the Department of the Interior and to all other federal agencies that are subject to the APA. By precluding enforcement of the compliance orders at issue here, which are based on the methodology developed in the procedure paper and modified by the IBLA, the court of appeals' judgment casts doubt on the Secretary's ability to enforce compliance with his interpretations of the regulatory "fair market value" standard unless he adopts each of those interpretations through notice-and-comment rulemaking. Such a result would be plainly unwarranted, and would frustrate the Secretary's ability to "audit and reconcile, to the extent practicable, all current and past lease accounts for leases of oil or gas and take appropriate actions to make additional collections or refunds as warranted." 30 U.S.C. 1711(c)(1).

Moreover, MMS must repeatedly apply royalty valuation rules to new or particular circumstances due to changes in the market and the often complex structure of production and distribution transactions. MMS cannot confidently predict changes in the market or in industry practices. Accordingly, the Secre-

tary's front-line compliance personnel should be able to confront interpretive questions promptly, efficiently, and uniformly as they arise, in order to have a sound basis for making initial enforcement policy decisions that relate to specific situations but that potentially affect a wide range of leases and lessees.

Neither the APA nor any other statute provides that the Secretary of the Interior—let alone divisions within one component of the Department—must develop every guideline, policy, and procedure necessary to aid agency auditors in evaluating lessees' royalty compliance by adopting substantive rules having the force of law. See, *e.g.*, *NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 293 (1974); *SEC* v. *Chenery Corp.*, 332 U.S. 194, 202-203 (1947); 1 K. Davis & R. Pierce, Jr., *Administrative Law Treatise* § 6.8 (3d ed. 1994). Nor is there any requirement that coordination of initial compliance or enforcement policies, to be enforced through subsequent orders and adjudicatory proceedings, must be accomplished without setting pen to paper, lest the resulting internal guidance be deemed a substantive rule.

The same principles apply, moreover, to every federal agency having compliance or enforcement responsibilities. Both the APA's definition of "rules" (which surely does not encompass every piece of paper produced or statement made by any agency official in any context, see *Lincoln* v. *Vigil*, 113 S. Ct. at 2034), and the exemptions from the APA's notice-and-comment requirement for those "agency statements" that are "rules," evince a judgment by Congress that agencies must have the ability to communicate and coordinate their activities internally, and to announce their own policies and interpretations to the public, without first providing for public

notice and comment. Whichever of the available (and sometimes overlapping) exemptions might most appropriately be said to apply in a case such as this one, together they surely permit the kind of agency activity reflected in the "procedure paper" at issue in this case to take place without resort to the rule-making procedures of the APA. The court of appeals' ruling to the contrary poses a serious threat to the orderly conduct of the government's administrative business. The decision below therefore merits review by this Court.

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JANUARY 1995

**APPENDIX A**

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

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No. 93-1377

PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT

*v.*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL., DEFENDANTS-APPELLEES

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ATLANTIC RICHFIELD COMPANY,
PLAINTIFF-APPELLANT

*v.*

BRUCE BABBITT, Secretary of Department of Interior, ET AL.,
DEFENDANTS-APPELLEES

---

PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT

*v.*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL., DEFENDANTS-APPELLEES

---

PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT,

*v.*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL., DEFENDANTS-APPELLEES

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Appeals from the United States District Court
for the Northern District of Texas

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June 10, 1994

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Before SMITH and BARKSDALE, Circuit Judges, WALTER,* District Judge.

JERRY E. SMITH, Circuit Judge:

In this consolidated appeal, plaintiffs Phillips Petroleum Company ("Phillips") and Atlantic Richfield Company ("Arco") appeal a summary judgment. Phillips and Arco contend that (1) the six-year limitations period of 28 U.S.C. § 2415(a) barred the administrative order issued by Minerals Management Service ("MMS") of the Department of Interior ("DOI") requiring the recalculation and payment of additional oil and gas royalties based upon an unpublished MMS royalty-valuation procedure (the "Procedure Paper"); (2) defendants failed properly to initiate an audit pursuant to the Federal Oil and Gas

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* District Judge of the Western District of Louisiana, sitting by designation.

Royalty Management Act ("FOGRMA"), 30 U.S.C. §§ 1701-1757; and (3) MMS promulgated the Procedure Paper without notice and comment required under the Administrative Procedure Act of 1982 ("APA"), 5 U.S.C. §§ 552, 553. Phillips further asserts that defendants failed to comply with the Paperwork Reduction Act, 44 U.S.C. §§ 3501-3520. Concluding that MMS promulgated a substantive rule without notice and comment, we reverse.

## I.

### A.

DOI is responsible for issuing and administering oil and gas leases for federal lands. 30 U.S.C. §§ 181, 223-237. FOGRMA directs the Secretary of Interior (the "Secretary") to establish "a comprehensive inspection, collection and fiscal and production accounting and auditing system to provide the capability to accurately determine oil and gas royalties, interest, fines, penalties, fees, deposits, and other payments owed, and to collect and account for such amounts in a timely manner." 30 U.S.C. § 1711(a). FOGRMA further provides that the Secretary "shall audit and reconcile, to the extent practicable, all current and past lease accounts for leases of oil or gas and take appropriate actions to make additional collections or refunds as warranted, . . . [and] may also audit accounts and records of selected lessees and operators." *Id.* § 1711(c)(1). MMS is the agency within the DOI that is responsible for auditing royalty payments on federal and Indian oil and gas leases.

Phillips and Arco hold numerous leases on federal and offshore lands. As lessees, they pay royalties to the government based upon the value of the produc-

tion saved, removed, or sold from the leased premises. Up until March 1, 1988, DOI considered several factors in determining the value of federal offshore production for royalty purposes:

> The value of production shall never be less than fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

30 C.F.R. § 206.150 (1987).

On December 14, 1984, MMS developed new criteria for valuing natural gas liquid products ("NGLP's"),[1] as set forth in an unpublished internal agency paper referred to as the "Procedure Paper." Instead of considering the range of the various types of prices prescribed in the governing regulation, the Procedure Paper focused entirely upon one type of price, the spot market price:

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[1] When natural gas is produced that contains a high volume of liquefiable hydrocarbons (commonly known as "wet" gas), the gas is sometimes processed to separate the liquids from the dry methane, or "residue," gas. The liquids are then fractionated to separate the NGLP's, such as ethane, propane, butane, and natural gasoline.

> MMS will take the highest and lowest published price for the month from the appropriate [spot market price] bulletin. If the reported price [by the lessee] falls within this range, the [lessee's] value will normally be accepted by MMS for royalty determination purposes. . . .
>
> . . . .
>
> If the prices used to calculate royalties fall below this range, a minimum value that is acceptable to MMS can be determined by developing an average value from the lowest and highest prices in the range.

In a September 6, 1989, order, MMS advised Arco that it had audited royalty payments under five of Arco's federal offshore leases for the month of September 1983. MMS directed Arco to recalculate its royalties under the five leases, using the Procedure Paper, for the period 1983-1989. In a September 7, 1989, order, MMS required Arco to recalculate and pay additional royalties for all federal offshore leases from 1983 to 1989. MMS sent Arco another order on September 29, 1989, requiring Arco to recalculate its royalties using the Procedure Paper for all federal offshore leases for a period from October 1980 to February 1988. MMS sent similar orders to Phillips in September 1989, requiring Phillips to recalculate and pay additional royalties, using the Procedure Paper, on all offshore leases between January 1977 and February 1988.

B.

Phillips filed three separate suits for declaratory and injunctive relief, disputing the validity of the MMS orders; at about the same time, Arco filed a

similar action in the same court. The four cases were consolidated, and the parties filed cross-motions for summary judgment. The district court allowed the government to file a counterclaim seeking judicial enforcement of the orders, concluding that the statute of limitations provision of 28 U.S.C. § 2415(a) did not apply to the contested orders, and granted summary judgment on the government's counterclaim.

## II.

The Procedure Paper is a "rule," and its promulgation constituted "rulemaking" within the meaning of the APA.[2] Section 553 of the APA provides that an agency must provide notice of a proposed rule in the *Federal Register* and afford an opportunity for interested persons to present their views. 5 U.S.C. § 553(b), (c). The required publication must be made not less than thirty days before the effective date of the proposed rule. *Id.* § 553(d). In promulgating the Procedure Paper, MMS did not attempt to comport with these requirements, as it argues that the requirements of § 553 do not apply to the APA.

The APA exempts "interpretative rules, general statements of policy, [and] rules of agency organiza-

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[2] Title 5 U.S.C. § 551(4) defines a "rule" as "an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes [various substantive agency functions] or practices bearing on any of the foregoing." Section 551(5) defines "rulemaking" as "agency process for formulating, amending, or repealing a rule." Indeed, MMS does not argue that its action was not rulemaking but only that the Procedure Paper was exempt from the APA's notice and comment provisions.

tion, procedure, or practice" from the notice and comment requirements. *Id.* § 553(b)(A). In the Procedure Paper itself, MMS attempted to avoid the notice and comment requirements of the APA by characterizing the rule as a "yardstick." The Interior Board of Land Appeals called the rule "essentially a policy guideline." *Conoco & ARCO Oil & Gas Co.*, 110 IBLA 232, 242-43 (1989). This court, however, must determine the category into which the rule falls: "[T]he label that the particular agency puts upon its given exercise of administrative power is not, for our purposes, conclusive; rather it is what the agency does in fact." *Brown Express, Inc. v. United States*, 607 F.2d 695, 700 (5th Cir.1979) (quoting *Lewis-Mota v. Secretary of Labor*, 469 F.2d 478, 481 (2d Cir.1972)). We review this legal issue *de novo*. *See Munn v. Algee*, 924 F.2d 568, 575 (5th Cir.), *cert. denied*, —— U.S. ——, 112 S.Ct. 277, 116 L.Ed.2d 229 (1991).

A.

MMS argues that the Procedure Paper merely interprets the existing royalty valuation regulation in the context of NGLP's used internally and not sold. It is therefore a clarification or explanation of existing laws and regulations rather than a substantive modification of existing regulations or adoption of new ones. *See Continental Oil Co. v. Burns*, 317 F.Supp. 194, 197 (D.Del.1970). Consequently, MMS concludes, the Procedure Paper is exempt from the notice and comment requirements as an "interpretative rule."

"Interpretative rules" have been defined by this court in *Brown Express:* "Generally speaking, it seems to be established that 'regulations,' 'substan-

tive rules,' or 'legislative rules' are those which create law, usually implementary to an existing law; whereas interpretative rules are statements as to what the administrative officer thinks the statute or regulation means." *Brown Express*, 607 F.2d at 700 (quoting *Gibson Wine Co. v. Snyder*, 194 F.2d 329, 331 (D.C.Cir.1952)). The Procedure Paper is not an interpretative rule, as it does not purport to interpret a statute or regulation. Notwithstanding MMS's asertion that the Procedure Paper merely announced the approach MMS would take in interpreting and applying 30 C.F.R. § 206.150, the Procedure Paper is not a mere clarification. It defines no ambiguous term. It gives no officer's opinion about the meaning of the statute or regulations. Rather, it effects a change in the method used by MMS in valuing NGLPs.[3] As such, it is a new rule and cannot be interpretative. *Brown Express*, 607 F.2d at 700.

B.

MMS also contends that the Procedure Paper may be characterized as a "general statement of MMS policy." A general statement of policy is a statement by an administrative agency announcing motivating factors the agency will consider, or tentative goals toward which it will aim, in determining the resolu-

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[3] MMS claims that the Procedure Paper effects no change because MMS could have used spot market prices to value NGLP's not sold. Under 30 C.F.R. § 206.150, "posted prices" are but one factor to be used in valuing NGLP royalties. And rules are viewed as substantive when they "constrict the discretion of agency officials by largely determining the issue addressed." *Batterton v. Marshall*, 648 F.2d 694, 702 (D.C. Cir.1980) (footnote omitted).

tion of a substantive question of regulation. *Id.* at 701.

> A general statement of policy . . . is merely an announcement to the public of the policy which the agency hopes to implement in future rulemakings or adjudications. A general statement of policy, like a press release, presages an upcoming rulemaking or announces the course which the agency intends to follow in future adjudications.

*Id.* (quoting *Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33, 38 (D.C.Cir. 1974)). The Procedure Paper, however, does none of these things. It does not set a goal that future proceedings may achieve, for the change has already been made. Immediately upon its effective date, the five-factor valuation technique of 30 C.F.R. § 206.150 was no longer to be followed. An announcement stating a change in the method by which an agency will value NGLP's is not a "general statement of policy." Thus, the Procedure Paper is not exempt from APA requirements as a "general statement of policy."

C.

Section 553(b)(A) also exempts "rules of agency organization, procedure, or practice." Although the Procedure Paper would appear to fall squarely within this exemption, for the change effected by the Procedure Paper plainly relates to the internal practices of MMS, the mere fact that it may guide MMS procedures does not mean that the Procedure Paper is a "procedural" rule for purposes of the APA.

The Supreme Court has stated that the notice and comment provisions "were designed to assure fairness

and mature consideration of rules of general application." *NLRB v. Wyman-Gordon Co.*, 394 U.S. 759, 764, 89 S.Ct. 1426, 1429, 22 L.Ed.2d 709 (1969). These provisions afford an opportunity for "the agency promulgating the rule to educate itself before establishing rules and procedures which have a substantial impact on those regulated." *Texaco, Inc. v. Federal Power Comm'n*, 412 F.2d 740, 744 (3d Cir. 1969). Congress realized that an agency's judgment would be only as good as the information upon which it drew. It prescribed these procedures to ensure that the broadest base of information would be provided to the agency by those most interested and perhaps best informed on the subject of the rulemaking at hand. *See Shell Oil Co. v. Federal Energy Admin.*, 574 F.2d 512, 516 (Temp.Emer.Ct.App. 1978).

The proper test to be applied in considering a rule that may arguably fall under the exemptions for "procedural rules" is as stated by *Brown Express:* "[W]hen a proposed regulation of general applicability has a *substantial* impact on the regulated industry, or an important class of the members or the products of that industry, notice and opportunity for comment should first be provided." *Brown Express*, 607 F.2d at 702 (citation omitted). The exemption of § 553(b)(A) from the duty to provide notice by publication does not extend to those procedural rules that depart from existing practice and have a substantial impact on those regulated. Our inquiry, therefore, is not whether the rule is "substantive" or "procedural," but rather whether the rule will have a "substantial impact" on those regulated.

We conclude that the Procedure Paper does have a substantial impact on those regulated in the industry. The rule narrowly restricts the discretion of MMS

officials in determining the value of NGLP's. It forecloses other valuation methods by prescribing binding valuation criteria. Although the regulation allows the use of *posted* prices in determining the value of NGLP's, the Procedure Paper mandates the use of *spot* prices.[4] Thus, the Procedure Paper does not even comport with the regulation in using posted prices. Moreover, the Procedure Paper eliminates the other four factors in determining the value of NGLP's.

This change in valuation technique dramatically affects the royalty values of all oil and gas leases. Thus, the Procedure Paper should have been published in the *Federal Register* and offered for notice and comment. A party may not be adversely affected by a rule promulgated in violation of these requirements. 5 U.S.C. § 552(a)(1).

III.

We conclude that the Procedure Paper is a substantive rule, and § 553 of the APA controlled its promulgation. We therefore REVERSE the summary judgment and REMAND for such further proceedings as may be necessary.

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[4] A posted price is a publicly announced price at which a purchaser is willing to buy a certain type and amount of petroleum products. Spot prices, on the other hand, reflect actual transactions on a short-term or one-time basis.

**APPENDIX B**

[Filed Apr. 16, 1993]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

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Civil Action No. 3-89-1707-H
Consolidated with
CA-3-89-2393-H; CA-3-89-2727-H;
CA-3-89-2751-H

PHILLIPS PETROLEUM COMPANY, PLAINTIFF

*v.*

NICK L. KELLY, ET AL., DEFENDANTS

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JUDGMENT

Pursuant to this Court's Memorandum Opinion and Order dated September 18, 1992, the Court hereby orders, adjudges and decrees that the orders and decisions of the Department of the Interior challenged in the above-numbered cases and requiring plaintiffs Atlantic Richfield Company and Phillips Petroleum Company to recompute and pay any unpaid royalties due to the government are valid and enforceable. Specifically, the Court orders as follows:

(1) In *Phillips Petroleum Co. v. Kelly*, No. CA-89-1707-H, Phillips is hereby ordered to comply with the challenged order dated June 5, 1989. That order requires Phillips to recompute and pay royalties on any proceeds received as Natural Gas Policy Act section 110 (Federal Energy Regulatory Commission Order

94) reimbursements on which royalty had not been paid for the period from July 25, 1980 to June 5, 1989, on all leases which Phillips acquired from General American Oil Company of Texas. Administrative Record Vol. I, No. 6.

(2) In *Phillips Petroleum Co. v. Kelly*, No. CA3-89-2727-H, Phillips is hereby ordered to comply with the order dated September 26, 1989, by recomputing and paying royalties on any proceeds received as Natural Gas Policy Act section 110 (FERC Order 94) reimbursements on which royalty had not been paid for the period from July 1980 until September 26, 1989, for all leases which Phillips acquired from Aminoil. Administrative Record Vol. II, No. 5.

(3) In *Phillips Petroleum Co. v. Kelly*, No. CA3-89-2751-H, Phillips is hereby ordered to comply with the order dated September 27, 1989, by recomputing and paying royalties on Natural Gas Liquid Products (NGLP) extracted from gas produced from all of its offshore leases for the period from January 1977 through February 1988, except for NGLP extracted at the North Terrebonne gas plant. Administrative Record Vol. III, No. 1.

(4) In *Atlantic Richfield Co. v. Lujan*, No. CA3-89-2393-H, ARCO is hereby ordered to comply with the orders dated September 6 and 7, 1989, by recalculating and paying royalties due on gas produced from Arco's offshore leases and processed through the Yscloskey gas plant and disposed of under non-arms-length arrangements using the Mont Belview, Texas prices prescribed in the Procedure Paper methodology for the sales months October 1983 through February 1988. Administrative Record Vol. VI, Nos. 2 and 3. ARCO is also ordered to comply with the September 29, 1989 order by recomputing and paying

additional royalties due for the NGLP extracted from gas produced from all of its Federal offshore leases and disposed of under non-arms-length arrangements using the same methodology for the period from October 1980 through February 1988 (except for gas processed at the Yscloskey gas plant, and limited to the period October 1981 through February 1988 for gas processed at the Grand Chenier gas plant). Administrative Record Vol. VI, No. 1.

(5) Finally, this Court affirms the decision of the Interior Board of Land Appeals in *Conoco, Inc. and ARCO Oil and Gas Co.*, 110 IBLA 232 (1989), challenged in *Atlantic Richfield Co. v. Lujan*, No. CA3-89-2393-H. Accordingly, the order dated March 31, 1986 and reviewed in that administrative appeal is valid and enforceable. ARCO is hereby ordered to pay additional royalties on NGLP on the basis of the Mont Belview spot price for the period dated January 1980 through April 1983.

IT IS FURTHER ORDERED that the complaints filed in cases numbered CA-3-89-1707-H, CA-3-89-2393-H, CA-3-89-2727-H, and CA-3-89-2751-H are hereby dismissed with prejudice. IT IS SO ORDERED.

/s/ Barefoot Sanders
United States District Court
Judge

DATED: April 16, 1993.

**APPENDIX C**

[Filed Mar. 26, 1993]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

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Civil Action No. 3-89-1707-H

(Consolidated with
3-89-CV-2393-H, 3-89-CV-2727-H,
and 3-89-CV-2751-H)

PHILLIPS PETROLEUM COMPANY, PLAINTIFF

*v.*

NICK L. KELLY, ET AL., DEFENDANTS

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ORDER

Before the Court are cross-motions for summary judgment on the government's counterclaim: Defendants' Motion for Summary Judgment on the Counterclaim, filed February 1, 1993; the Memorandum of Phillips Petroleum Company ("Phillips") in Response to Defendants' Motion for Summary Judgment on Counterclaim, filed January 25, 1993: and the Opposition of Atlantic Richfield Company ("ARCO"), filed February 25, 1993. Also before the Court are ARCO's Motion for Summary Judgment on Counterclaim, filed December 15, 1992; Phillips' Motion for

Summary Judgment on Federal Defendants' Counterclaim, filed February 1, 1993; and Defendants' Response to Plaintiffs' Motions for Summary Judgment on the Counterclaim, filed February 25, 1993.

The Court's September 18, 1992 Memorandum Opinion and Order seems to be the source of some confusion. To clarify, that order ruled that the MMS's orders issued to Phillips and ARCO were valid and enforceable. The Court's judgment will reflect that the challenged orders will be enforced.

It is important to note that the Court's discussion of the statute of limitations found in 28 U.S.C. § 2415 applies only to an "action for money damages." However, no such action is currently pending; the Court's discussion of section 2415 indicates how the Court would treat a claim for money damages if one were to be filed. *See Phillips Petroleum Company v. Kelly, et al.*, No. 3:89-CV-1707-H (N.D. Tex. filed September 18, 1992) at 23 ("[T]he Court concludes that the six year statute of limitations period affords the MMS ample time to investigate, verify, and choose the causes of action that it *will* pursue.") (emphasis added); 51 ("[T]he Government is precluded from bringing any causes of action against Phillips and ARCO based on royalty payments on the leases at issue here more than six years after the payments are due."). Thus, section 2415 has no direct application to the MMS orders. *See S.E.R., Jobs for Progress, Inc. v. United States*, 759 F.2d 1, 5 (Fed. Cir. 1985).[1]

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[1] The Court notes that the Fifth Circuit has questioned a portion of the *S.E.R., Jobs for Progress, Inc.* decision. *See United States v. Popovich*, 820 F.2d 134 (5th Cir.), *cert. denied*, 484 U.S. 976 (1987). However, *Popovich* only addressed the portion of *S.E.R., Jobs for Progress, Inc.* which discussed laches.

In its counterclaim, the government asks for an injunction to enforce the Court's September 18, 1993 order. To the extent that the government's counterclaim seeks to enforce the Court's judgment, it is GRANTED.[2] To the extent that the government's counterclaim seeks further relief, it is DENIED without prejudice.

The government is DIRECTED to submit by *noon, April 8, 1993* a proposed judgment which provides the remedies spelled out in the Court's September 18, 1992 Memorandum Opinion and Order—*i.e.*, that the IBLA decision and the MMS' orders to recompute and pay any unpaid royalties due to the government are valid and enforceable.

SO ORDERED.

DATED: March 26, 1993.

/s/ Barefoot Sanders
BAREFOOT SANDERS
Chief Judge
United States District Court
Northern District of Texas

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[2] The Court notes that it retains the inherent power to enforce its judgments; the Court will do so when and if circumstances require enforcement of the judgment in this case.

**APPENDIX D**

[Filed Sep. 18, 1992]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

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Civil Action No. 3-89-CV-1707-H

(Consolidated with
3-89-CV-2393-H, 3-89-CV-2727-H,
and 3-89-CV-2751-H)

PHILLIPS PETROLEUM COMPANY, PLAINTIFF

*v.*

NICK L. KELLY, Area Manager, Dallas Area Compliance Office, Minerals Management Service; BARRY WILLIAMSON, Director, Minerals Management Service of the Department of the Interior; MANUEL LUJAN, JR., Secretary of the Interior; MINERALS MANAGEMENT SERVICE of the United States Department of the Interior; and the UNITED STATES DEPARTMENT OF THE INTERIOR, DEFENDANTS

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MEMORANDUM OPINION AND ORDER

Before the Court are three overlapping motions for summary judgment:

1.) Plaintiff Phillips Petroleum Company's ("Phillips") Motion for Partial Summary Judg-

ment, filed August 16, 1991; Defendants' (collectively, for simplicity purposes, "the Government") Memorandum in Opposition thereto, filed October 18, 1991; Phillips's Supplemental Reply, filed July 9, 1992;

2.) Plaintiff Atlantic Richfield Company's ("ARCO") Motion for Summary Judgment, filed August 16, 1991; the Government's response thereto (contained in its October 18, 1991, Memorandum in Opposition); and ARCO's Reply, filed July 9, 1992;

3.) The Government's Motion for Partial Summary Judgment, filed May 16, 1991; ARCO's Brief in Opposition thereto, filed October 4, 1991; Phillips's Brief in Response and Opposition, filed October 18, 1991; and Defendants' Supplemental Brief, filed July 10, 1992.

Related to these motions are Plaintiffs' Joint Supplemental Brief, filed November 25, 1991; Defendants' Response thereto, filed December 6, 1991; Phillips's Reply, filed December 24, 1991; ARCO's Reply, filed January 6, 1992; and Defendants' Surreply, filed January 15, 1992. Finally, before the Court are Phillips's Brief In Re the One-Year Grace Period Provision of 28 U.S.C. § 2415, filed September 15, 1992; ARCO's Supplemental Brief, filed September 15, 1992; and the Government's Supplemental Brief Regarding One-Year Proviso of 28 U.S.C. 2415, filed September 15, 1992.

## I. Background

Phillips and ARCO each produce oil and natural gas throughout the world. Among the leases they

hold enabling them to do so are ones located on the outer continental shelf of the United States ("OCS") on lands owned by the federal government. Pursuant to the Outer Continental Shelf Lands Act, the Secretary of the Interior ("the Secretary") is responsible for the management of OCS leases. *See* 43 U.S.C.A. § 1337(a)(1) (West 1986). The Federal Oil and Gas Royalty Management Act ("FOGRMA") authorizes the Secretary to audit, and collect royalties on, these leases. *See* 30 U.S.C.A. § 1711 (West 1986); 30 U.S.C.A. §§ 181, 223-37 (West 1986 & Supp. 1992); *see also* 30 U.S.C.A. §§ 181-287 (West 1986) (awarding the Secretary, via the Mineral Land Leasing Act, responsibility for mineral lands leases).

Pursuant to these statutory provisions and the terms of the OCS leases at issue in this suit, *see* Affidavit of S. Mark Haugland, filed August 16, 1991, Exhibits A-D, Phillips and ARCO paid monthly royalties to Defendant Minerals Management Service ("MMS"),[1] a division of Defendant Department of the Interior ("DOI"),[2] for the right to extract oil and gas from the leased properties. The MMS carries out its responsibilities through the Royalty Management Program.

Based on audits of sample OCS leases for production between October 1, 1980, and September 30, 1983, the MMS determined that Phillips and ARCO had underpaid royalties on natural gas liquid prod-

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[1] Beginning in 1982, the Secretary delegated the administrative responsibility for OCS leases to the MMS. *See* Secretarial Order No. 3071 (Jan. 19, 1982), 47 Fed. Reg. 4757 (Feb. 2, 1982).

[2] The remaining Defendants are individual officers of MMS or the DOI sued in their respective capacities as such.

ucts ("NGLP's") produced on the OCS leases at issue here and used internally by Phillips and ARCO without being sold.[3] The MMS concluded that, in some cases, the underpayments were the result of Phillips and ARCO undervaluing the gas produced and, in other cases, the result of Phillips failing to pay on reimbursements for production-related costs. In all instances, the MMS determined that the alleged undervaluations were systemic shortcomings, meaning that they recurred with each royalty calculation.

Between June and September 1989, the MMS notified Phillips and ARCO of its determinations and directed both to recalculate royalties due on the OCS leases at issue for the periods in question.[4] *See* Administrative Record ("A.R."), Vol. I, No.'s 5, 6; Vol. II, No. 5; Vol. III, No. 1; Vol. VI, No.'s 1, 2, 3. Phillips and ARCO, disputing the MMS's calculation methods, filed the instant suits, Phillips initiating Civil Action No.'s CA3-89-CV-1707-H, CA3-89-CV-2727-H, and CA3-89-CV-2751-H, and ARCO bringing Civil Action No. CA3-89-CV-2393-H. In their respective actions, Phillips and ARCO seek declaratory

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[3] The leases involved are Phillips's No. OCS-G 2712, No. OCS-G 2301, No. OCS-G 2302; ARCO's lease No.'s 054-002919-0, 054-002636-0, 054-002637-0, 054-002640-0, and 054-004501-0; and eight leases identified as those acquired through a January 1, 1985, merger of Aminoil, Inc., into Phillips. The MMS approved the Aminoil merger on March 1, 1985, *see* A.R., Vol. II, No. 8, and its royalty calculation efforts were not delayed by it. *See* A.R., Vol. III, No.'s 1, 7, 11.

[4] The MMS's orders were given in letters addressed to Phillips's Bartlesville, Oklahoma, office and dated June 5, 1989, June 12, 1989, September 26, 1989, and September 27, 1989, respectively, and letters addressed to ARCO and dated September 6, 7, and 29, 1989, respectively.

judgments that the MMS orders are unlawful and injunctions enjoining Defendants from enforcing the orders in any respect. This Court consolidated the cases because the issues presented in all four overlap significantly. *See* Order of Consolidation, filed March 2, 1990.

Specifically, Phillips and ARCO maintain that, 1.) the statute of limitations codified at Title 28, United States Code, Section 2415(a) ("Section 2415[a]"), bars collection of royalties due and owing more than six years before the respective MMS orders were issued;[5] 2.) the MMS lacks authority to order the recalculations at issue because they amount to self-audits barred by FOGRMA; and 3.) the MMS's valuation procedures were invalid.[6] With respect to the latter issue, two of the consolidated cases[7] involve challenges to the MMS's assessments of reimbursements for production-related costs received based on orders from the Federal Energy Regulatory Commis-

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[5] The relevant dates for the purposes of Section 2415(a) are the dates on which the Government files complaints, and not the dates of the MMS's orders. *See* 28 U.S.C.A. § 2415(a) (West Supp. 1992); *infra* pp. 9-10. Phillips and ARCO's implied position is that, if the MMS orders fell after the limitations period had expired, then subsequent Government suits would fall likewise, and, hence, be barred.

[6] Pivotal too is the parties' agreement that the agency orders at issue in this case are final for the purposes of review by this Court. *See* A.R., Vol. I, No.'s 1, 2; A.R., Vol. II, No.'s 1, 2; A.R., Vol. IV, No. 1; First Joint Status Report, filed October 27, 1989; Defendants' Motion for Partial Summary Judgment at 4, 6, 8; Phillips's Brief in Support of its Cross Motion for Partial Summary Judgment, filed August 16, 1991, at 2.

[7] Cases CA3-89-CV-1707-H and CA3-89-CV-2727-H.

sion ("FERC"), and two [8] involve challenges to royalty valuation regulations that were based on the "Procedure Paper on Natural Gas Liquid Products Valuation" ("Procedure Paper"). ARCO also challenges a decision of the Interior Board of Land Appeals ("IBLA") upholding use of the Procedure Paper by the MMS.

Phillips, ARCO, and the Government each move for summary judgment on all issues except the challenges based on the FERC orders. After reviewing the necessary summary judgment tenets, the Court addresses each issue in turn.

## II. Summary Judgment

Summary judgment is proper when the pleadings and evidence on file show that no genuine issue exists as to any material fact and that the moving party is entitled to judgment or partial judgment as a matter of law. Fed. R. Civ. P. 56. "Before a court may grant summary judgment, the moving party must demonstrate that it is entitled to judgment as a matter of law because there is no actual dispute as to an essential element of the plaintiff's case." *Christopher-sen v. Allied-Signal Corp.*, 902 F.2d 362, 364 (1990), *opinion superseded on other grounds*, 939 F.2d 1106 (1991), *cert. denied*, 112 S. Ct. 1280 (1992).

The Supreme Court has explained that a movant for summary judgment does not bear the burden of negating the nonmoving party's case with evidence; rather, the movant must show only that the opponent's case lacks the evidence it needs to support it. *See Celotex Corp. v. Catrett*, 477 U.S. 317, 324-26 (1986). The Fifth Circuit has held likewise, noting

[8] Cases CA3-89-CV-2393-H and CA3-89-CV-2751-H.

that the moving party is entitled to summary judgment when the motion's opponent fails to make a sufficient showing of proof, *see Skotak v. Tenneco Resins, Inc.*, 953 F.2d 909, 920 (5th Cir. 1992) (quoting *Fontenot v. Upjohn Co.*, 780 F.2d 1190, 1195-98 [5th Cir. 1986]), although the evidence must be viewed in the light most favorable to the motion's opponent. *See Gremillion v. Gulf Coast Catering Co.*, 904 F.2d 290, 292 (5th Cir. 1990); *reh'g denied*, 909 F.2d 1479 (1990).

In sum, "(i)f the record taken as whole could not lead a rational trier of fact to find for the nonmoving party, there is no genuine issue for trial." *Friou v. Phillips Petroleum Co.*, 948 F.2d 972, 974 (5th Cir. 1991) (citing *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 [1986]).

## III. Statute of Limitations

The Secretary is authorized to "establish a comprehensive inspection, collection and fiscal and production accounting and auditing system to provide the capability to accurately determine oil and gas royalties, interest, fines, penalties, fees, deposits, and other payments owed, *and to collect and account for such amounts in a timely manner.*" 30 U.S.C.A. § 1711(a) (West 1986) (emphasis added). In the present MMS orders, the Government seeks royalties on OCS leases for periods beginning as far back as January 1977, *see* A.R., Vol. III, No. 1, and the Court is now confronted with the issue of how forgiving of delays such as these Congress intended FOGRMA and Section 2415(a) to be. Phillips and ARCO assert that Section 2415(a) bars recovery of any royalties due and owing more than six years before the MMS orders of June and September, 1989. In addition,

Phillips argues that the Government is barred from contesting the statute of limitations issue because the same issue was litigated in *Phillips Petroleum Co. v. Lujan*, No. 88-C-1487-E, 1989 WL 239616 (N.D. Okla. October 18, 1989).

*Collateral Estoppel*

As all parties now note, the decision in that case recently was reversed by the Tenth Circuit in *Phillips Petroleum Company v. Lujan*, 951 F.2d 257, 261 (1991) (*"Phillips I"*). Therein, Phillips sued the same defendants as are present in this case, challenging a September 30, 1988, MMS order requiring it to produce records relating to oil and gas leases for the period October 1, 1980, through September 30, 1983. Phillips, argued, *inter alia*, that the order was barred by a six year statute of limitations, now codified at Title 28, United States Code, Section 2415. *Id.* at 259. The district court agreed and entered summary judgment in favor of Phillips. *Id.*

In reversing, the Tenth Circuit explained that the statutory provision authorizing the DOI to require lessees to maintain and provide records (30 U.S.C.A. 1713[a] [West 1986] was not subject to the statute of limitations. *Id.* at 259-60. To resurrect any meaningful impact from its collateral estoppel argument, Phillips now asks the Court to conclude that *Phillips I* was incorrectly decided and to adopt the district court's statute of limitations reasoning.

The Court finds no applicable reasoning to adopt. The issues in this case are distinct from those of *Phillips I*; at stake here are MMS orders to pay royalties, while *Phillips I* involved an MMS order to pro-

duce documents.[9] The court in *Phillips I* also noted that,

> Defendants were not asserting a claim for underpayment of royalties. Had they been, plaintiff might have very well been able to assert a statute of limitations defense. Rather, defendants were merely ordering plaintiff to provide records. Such an order is well within defendants' authority under the lease agreements and under the pertinent statutes and regulations governing the management of royalty payments.

951 F.2d at 259-60.

Because there were no audits or royalty valuations at issue in *Phillips I*, the Court concludes that the *dicta* quoted above simply explains when the Section 2415(a) limitations period is generally applicable in FOGRMA royalty cases. This conclusion is supported by the Tenth Circuit's subsequent declaration that, "(i)n *Phillips I*, we clearly held that although § 2415 may provide a legitimate defense to a claim for underpayment of royalties, it does not apply to limit the DOI's right under the FOGRMA to order lessees to maintain and provide records." *Phillips Petroleum Co. v. Lujan*, 963 F.2d 1380, 1386 (1992); *see infra* pp. 26-27.

*Sections 2415(a) and 2416*

The applicable statute of limitations inquiry begins with Section 2415(a), which provides that,

> (s)ubject to the provisions of section 2416 of this title, and except as otherwise provided by

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[9] Thus, the collateral estoppel argument is misdirected.

> Congress, every action for money damages brought by the United States or an officer or agency thereof which is founded upon any contract express or implied in law or fact, shall be barred *unless the complaint is filed within six years after the right of action accrues* or within one year after final decisions have been rendered in applicable administrative proceedings required by contract or by law, whichever is later . . . .

28 U.S.C.A. § 2415(a) (West Supp. 1992). All parties agree that the six year limitations period governs the present causes of action. *See* Phillips's September 15, 1992 Brief, at 1; ARCO's September 15, 1992 Brief, at 1-2; Defendants' September 15, 1992 Brief, at 1; First Joint Status Report, filed April 9, 1990, at 2. Likewise, it is clear that the period will apply independently to each monthly royalty payment at issue. The questions are when the causes of action accrued and whether the six year period ever tolled subject to the referenced Section 2416.

Section 2416 reads as follows:

> For the purpose of computing the limitations periods established in section 2415, there shall be excluded all periods during which . . . facts material to the right of action are not known and reasonably could not be known by an official of the United States charged with the responsibility to act in the circumstances . . . .

28 U.S.C.A. § 2416 (West 1978).

Phillips and ARCO argue that a cause of action for underpayment of royalties accrues on the date that the royalties were due and that the Section 2415(a) period is tolled only in cases of fraud. The

Government would have each cause of action accrue when the MMS completes the pertinent audit showing that royalties have been underpaid,[10] pointing to a set of Medicare reimbursement cases in support of its position.

In the alternative, the Government argues that it reasonably could not have known that Phillips and ARCO underpaid royalties until the MMS had completed its audits and that the six year limitations period should have been tolled until that point. Noting the MMS's mountainous workload, the Government posits that it is not feasible for the MMS "to review each monthly payment as it is made." Memorandum in Support of Defendants' Motion for Partial Summary Judgment, at 27. Phillips and ARCO counter that such a view allows the Government to complete audits at its discretion because the six year period would not even begin to run until an audit is completed.

Thus, the Government asks the Court to categorically allow all audits to be completed before commencing the limitations period,[11] and Phillips and ARCO ask the Court to categorically require that all audits

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[10] At one point, the Government suggests that Phillips and ARCO routinely revise their royalty reports and that the statute of limitations should not begin to run until royalty records are complete. There is no evidence that Phillips or ARCO revised their royalty reports or the payments at issue.

[11] All of the audtis in this case were completed within six years of the corresponding MMS orders. *See, e.g.*, A.R., Vol. III, No. 11 (documenting that the audit on what originally were Aminoil leases was completed on September 30, 1983); *id.* at No. 1 (evidencing that MMS order was issued on September 27, 1989).

be completed and actions filed within the limitations period.

The parties' arguments demonstrate that Sections 2415(a) and 2416 blend almost to indistinction in this case. Indeed, the Government's alternate arguments are, in effect, identical. In the Government's script, royalty underpayment causes of action accrue and are tolled at the same instant—the point when royalties are due.[12]

This merging, however, is no reason to ignore the accrual-tolling distinction inherent in the language of Sections 2415(a) and 2416, a distinction which may well be vital in other royalty cases. The Court's analysis proceeds accordingly.

*Accrual of the Causes of Action*

"No cause of action generally accrues until the plaintiff has a right to enforce his cause." *United*

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[12] The Government relies on *Frey v. Production Co.*, 943 F.2d 578 (5th Cir. 1991), *opinion withdrawn in part on reh'g*, 951 F.2d 67 (5th Cir. 1992). There, the Fifth Circuit construed a Louisiana statute providing that royalty underpayment claims were subject to what was, in effect, a statute of limitations. 943 F.2d at 586. The statute declared that the three year period "commences to run from the day payment is eligible." *Id.* (quoting La. Civ. Code Ann. arts. 3494(5), 3495 [West Supp. 1991]). Despite the statute's plain language, the court concluded that the three year period did not begin to run "until the plaintiff could have known through the exercise of reasonable diligence that they had such a cause of action against Amoco." *Id.* at 587. The court held that payment by the lessee could not create knowledge of an underpayment in the lessor unless an inconsistency was obvious on the face of a royalty payment statement. *Id.* While the statute of limitations issues in *Frey* closely parallel the ones here, *Frey* involved Louisiana law.

*States v. One 1961 Red Chevrolet Impala Sedan*, 457 F.2d 1353, 1358 (5th Cir. 1972) (citations omitted). More to the point with respect to this case, a cause of action based on contract generally accrues at the time of breach. *Pinnacle Port Community Ass'n. Inc. v. Orenstein*, 952 F.2d 375, 377 n.2 (11th Cir. 1992); *United States v. Kass*, 740 F.2d 1493, 1497 (11th Cir. 1984). The alleged breaches in the extant case occurred whenever royalties became due and were not fully paid. *See also United States v. Kass*, 740 F.2d at 1497 (ruling that, for Section 2415[a] purposes, Government's cause of action against doctor for Medicare overcharges accrued when overpayments were made); *Foster v. Atlantic Refining Co.*, 329 F.2d 485, 490 (5th Cir. 1964) (determining, in applying Texas law, that the applicable "statute [of limitations] begins to run on money due as royalty under a written contract when such money is due and payable"). Consistent with that conclusion are statutory and regulatory provisions that interest on unpaid royalties accrues beginning on the date that the royalties were due. *See, e.g.*, 30 U.S.C.A. § 1721(a), (f) (West 1986) (authorizing the Secretary to charge interest on underpaid royalties "for the number of days a payment is late"); 30 C.F.R. § 218.54(a) (1987) (declaring that, "[a]n interest charge shall be assessed on unpaid and underpaid amounts from the date the amounts are due"). In this case, there is no reason to conclude that the royalty causes of action accrued at any times other than the times of alleged breach.

The Medicare reimbursement cases, in which the Government sued for Medicare overpayments, while flush with cause of action accrual analyses, are notably distinguishable from the present action. The

Medicare Act, 42 U.S.C.A. §§ 1395-95ccc (West 1992 & Supp. 1992), authorizes, in "Part A," hospital benefits for the aged and disabled. The Part A scheme, as constructed at the time, *see* 42 C.F.R. §§ 405.405, 405.06, 405.454, 405.1803 (1983),[13] was specific: First, insurance providers were reimbursed during the year for estimated services. 42 C.F.R. §§ 405.405, 405.454 (1983). Thereafter, as the First Circuit succinctly summarized in *United States v. Hughes House Nursing Home, Inc.*,

> (a)t the end of each year, the provider is to give (a fiscal) intermediary a statement of its actual costs, 42 C.F.R. § 405.406(b); the intermediary will then make an 'initial retroactive adjustment' bringing the money that the provider received in line with its costs as revealed in the statement. 42 C.F.R. § 405.454(f)(2). Subsequently, the intermediary is to audit the cost reports, to determine the 'reasonable cost' of the services. This audit 'constitute(s) the basis' for a *final* 'retroactive adjustment.' 42 C.F.R. § 405.1803(b); *see* 42 U.S.C. § 1395x(v)(1)(A)(ii).

710 F.2d 891, 893 (1983) (emphasis in original). Consequently, when payments to the insurance provider are made under the Medicare Part A recovery

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[13] The present version of Section 405.405 can be found at 42 C.F.R. § 413.60 (1991); the present version of Section 405.454 can be found at 42 C.F.R. § 413.64 (1991); and the present version of Section 405.406 can be found at 42 C.F.R. § 413.20 (1991). *See* 51 Fed. Reg. 34790 (Sept. 1986). Section 405.1803, *see* 42 C.F.R. § 1803 (1991), was modified slightly in 1984, *see* 49 Fed. Reg. 322 (Jan. 1984), and again in 1986. *See* 51 Fed. Reg. 34793 (Sept. 1986).

scheme, they are only estimates of amounts due, and, by definition, no cause of action could accrue based on payments that are mere estimates.

Further, the scheme's lock-step progression must be completed before a plaintiff "has a right to enforce his (or her) cause" of action. *United States v. One 1961 Red Chevrolet Impala Sedan*, 457 F.2d at 1358; *see supra* p. 12.[14] As the court stated in *United States v. Gottlieb*,

> under the statutory scheme, no 'final adjustment' is contemplated until 'an audit is made and the final liability of the program is determined.' . . . (N)o suit should be maintained until the final adjustment has been attempted as provided in the regulations. Therefore, until an attempted final adjustment, it cannot be said that plaintiff has a right to enforce his claim.

424 F. Supp. at 420-21 (quoting 20 C.F.R. § 405.454 [f][2][1976]).[15]

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[14] For Section 2415(a) purposes, several courts have held that, due to the scheme, the Government's cause of action for Medicare overpayments accrues either when the final audit is completed or when the final retroactive adjustment is made. *See, e.g., United States v. Hughes House Nursing Home, Inc.* 701 F.2d at 894-95 (holding that cause of action accrues when final adjustment is made); *United States v. Gravette Manor Homes*, 642 F.2d 231, 234-35 (8th Cir. 1981) (holding likewise); *United States v. Withrow*, 593 F.2d 802, 806 (7th Cir. 1979) (deciding that cause accrues when audit is completed); *United States v. Graham*, 471 F. Supp. 123, 125 (S.D. Tex. 1979) (endorsing final adjustment rationale); *United States v. Gottlieb*, 424 F. Supp. 417, 420-21 (S.D. Fla. 1976) (similarly endorsing final adjustment rationale).

[15] One other case offered by the Government, *United States v. International Assoc. of Firefighters*, 716 F. Supp. 656

No such scheme for royalty recovery is mandated by FOGRMA; that an OCS lease account will be audited at all is guaranteed only "to the extent (it is) practicable" for the Secretary to conduct the audit. 30 U.S.C.A. § 1711(c)(1) (West 1986). Phillips and ARCO's royalty payments must be assumed final for the purposes of Section 2415(a). The Government had the right to enforce the present causes of action when the royalty payments were due and allegedly underpaid in breach of the OCS leases, even though the precise amount of damages may not have been determined until later. *See United States v. Gavilan Joint Community College Dist.*, 849 F.2d 1246, 1249-50 (9th Cir. 1988); *infra* p. 22.

The Government's position is problematic for other reasons. Were the Government's cause of action to accrue when the MMS completed an audit, it would allow the MMS to initiate and complete audits at its leisure, thereby giving it complete control over when the six year limitations period commences. Such unfettered discretion could leave OCS and other lessees open to royalty-based litigation on a given lease for unnumbered years and would eviscerate the limitations period. The purpose of FOGRMA is "to require the development of enforcement practices that ensure the prompt and proper collection and disbursement of oil and gas revenues owed to the United States . . . ." 30 U.S.C.A. § 1711(b)(3) (West 1986). As the Ninth Circuit put it in *United States v. Joint Community College Dist.*, a case in which the Government sued to recover alleged overpayments of tuition and

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(D.D.C. 1989), involving audits in the mineral leasing context, likewise hinges on a specific administrative scheme that dictates when the Government can sue. *See id.* at 657-60.

the same basic Section 2415(a) accrual question was at issue, "the Government here essentially asserts that it may postpone litigation indefinitely through delay in conducting its own audit. This is not a tenable position." 849 F.2d at 1249-50.

The Medicare Part A scheme, by contrast, explicitly provides a remedy if the audit and final determinations involved are not timely made. There, a provider who has not received a final determination within twelve months after filing the necessary reports is entitled to a hearing before the Provider Reimbursement Review Board. *See* 42 U.S.C.A. § 1395oo(a)(1) (West 1992); 20 C.F.R. § 405.1835 (1987).

To be sure, the MMS has statutory encouragement to initiate and complete its audits of OCS leases quickly. This, however, is no guarantee of prompt action. The Government, itself, represents that the MMS has taken on a heavy workload, and OCS lessees should not be penalized if it is unable to keep up. In this case, for example, Phillips was not ordered to recalculate certain royalties due for January 1977 until September 1989. *See* A.R., Vol. III, No. 1. The burden of maintaining records and anticipating litigation for uncounted years is not consistent with Section 2415(a), which was "designed to promote diligence by the government in bringing claims to trial and also to make the position of the government more nearly equal to that of a private litigant." *United States v. Kass*, 740 F.2d at 1496[16] (citing

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[16] *Kass* involved Medicare *Part B* overpayment recovery claims. The Medicare Act's Part B scheme affords supplementary medical insurance benefits for the aged and disabled. 740 F.2d at 1494-95. Unlike Part A's very specific lock-step progression, Part B, just like FOGRMA's royalty payment

*United States v. Cardinal*, 452 F. Supp. 542 [D. Vt. 1978] and S. Rep. No. 1328, 89th Cong., 2d Sess., *reprinted in* 1966 U.S.C.C.A.N. 2502).

The Government also argues that "the Interior's acceptance of the monthly royalty payments plainly is not a final determination of the royalty due," citing an IBLA decision [17] in support. Defendant's Memorandum in Opposition at 10 n.6. This view recycles the audit completion argument and would allow the Government to extend the time when each monthly royalty is due until the Government completes its audit. For reasons already discussed, this view is rejected.

The Court concludes that, for Section 2415(a) purposes, causes of action for underpayment of royalties on OCS leases accrue on the dates that the royalties are due and payable.

*Tolling the Limitations Period*

The Government, in its alternate argument, would have the Court toll the limitations period at the same time that it commenced. Citing the MMS's heavy workload,[18] the Government reasons that, "(t)o audit each one (lease) every month to verify the correctness of royalty payments immediately after they are

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scheme, requires only that payments be accurately and fully accounted for at the time that they are made. *See* 42 U.S.C.A. §§ 1395u(a), (b) (West 1992 & Supp. 1992).

[17] *Cities Service oil and Gas Corp.*, 113 IBLA 255 (1990).

[18] As of December 31, 1989, the MMS was responsible for some 24,000 federal and Indian oil and gas leases. *See* MMS, Minerals Revenues 1989: Report on Receipts from Federal and Indian Leases 83 (1989).

made would require an army of auditors," Defendants' Memorandum in Opposition at 14, and that, without a complete audit, the MMS reasonably could not have known the facts material to any cause of action it might have.

The issue, however, cannot be framed around the MMS's workload and is not a matter of requiring monthly audits of every OCS lease. Indeed, the same reasoning behind the accrual of the Government's causes of action when royalties are due and underpaid prevents the Section 2415(a) limitations period from tolling.

In fact, the support for excluding periods of administrative delay from the Section 2415(a) limitations period is less than overwhelming. Section 2416's legislative history plainly establishes fraud as the driving force behind the "facts . . . not known and reasonably could not have been known" exclusion. The history states that,

> (t)he committee understands that the principal application of this exclusion will probably be in connection with fraud situations. An example would be where the affirmative act of a wrongdoer has served to conceal the fraudulent act. This type of exclusion is to be found in the law of many States in both fraud and tort limitations. The material facts that are not known must go to the very essence of the right of action.

S. Rep. No. 1328, 89th Cong., 2d Sess., *reprinted in* 1966 U.S.C.C.A.N. 2502, 2507-08. In the Eleventh Circuit's words, "[f]oremost in the enactment of § 2416 was the thought that the government should not be penalized if the *fraud* of an adverse party restricted its ability to discover a valid cause of action

until long after its accrual." *United States v. Kass*, 740 F.2d at 1497 (emphasis in original). Echoes the Ninth Circuit, "[t]he legislative history expressly states that the principal application of this exclusion was intended for situations involving fraud." *United States v. Gavilan Joint Community College Dist.*, 849 F.2d at 1249-50; *see also United States v. Batson*, 706 F.2d 657, 676-77 & n.30 (5th Cir. 1983) (referring in *dicta* to the primacy of the fraud rationale).

There is no evidence of fraud in this case.

Still, the same history offers a modicum of support for excluding from the limitations period some delay that can be attributed to the ponderous innerworkings of the Government's administrative agencies. The history includes this charge:

> Paragraph (c) of section 2416 excludes the time when facts material to the right of action are not known and reasonably could not be known by an official of the United States charged with responsibility to act in the circumstances. This provision is required because of the difficulties of Government operations due to the size and complexity of the Government. It is not intended that the application of this exclusion will require the knowledge at the highest level of the Government. Responsibility in such matters may extend down to lower managerial levels within an agency.

S. Rep. No. 1328, 89th Cong., 2d Sess., *reprinted in* 1966 U.S.C.C.A.N. 2502, 2507. The length of delay that Congress intended be excusable under this rationale, however, is unclear. *See also United States v. Kass*, 740 F.2d at 1497 (opining that Congress envisioned "some delay"); *United States v. Incorpo-*

*rated Village of Island Park*, 791 F. Supp. 354, 372 (E.D.N.Y. 1992) (stating that, "[t]here is a reasonable question whether or not Section 2416[c] simply codifies the doctrine of fraudulent concealment").

At the outset, under the Section 2416 administrative delay rationale, there is no summary judgment evidence in this case from which the Court can exclude Section 2416 time periods from the Section 2415(a) limitations period. There is no evidence about the MMS's diligence in pursuing the audits involved and no evidence about the timing of the MMS' knowledge of the alleged underpayments beyond its correspondence to Phillips and ARCO based on the completion of its audits. *See* A.R., Vol. I, No.'s 5, 6; Vol. II, No. 5; Vol. III, No. 1; Vol VI, No.'s 1, 2, 3 (including references to earlier notices).

The Court also rejects the Government's request to categorically toll the limitations periods regarding the leases at issue until the completion of the pertinent audits. The Court concludes that Section 2416 supports no such administrative delay. At the fore of the Court's consideration is a recurring potential for unfettered MMS discretion in the timing, and diligent pursuit, of its audits. *See supra* pp. 16-18. Because realization of that potential would be grossly unfair to OCS lessees; because any hints of an administrative delay rationale behind Section 2416 are secondary to that regarding fraud; and because the administrative delay rationale more directly runs contrary of the very purpose of Section 2415(a), the Court is of the opinion that the extent to which courts should tolerate such delay is lessened. This position is bolstered by the sense of urgency in FOGRMA, specifically, FOGRMA's goal of "prompt and proper collection and disbursement of oil and gas revenues," 30 U.S.C.A.

§ 1711(b)(3) (West 1986); *see supra* p. 16, and the Secretary's duty to collect and account for amounts due "in a timely manner." 30 U.S.C.A. § 1711(a) (West 1986); *see supra* p. 7.

As the Eleventh Circuit noted in *United States v. Kass*, the counsel of Section 2416's legislative history is that the "facts material to the right of action" are "the facts making up the "very essence of the right of action." *See* 740 F.2d at 1498 (1984) (relying on S. Rep. No. 1328, 1966 U.S.C.C.A.N. at 2508); *see also United States v. Beck*, 758 F.2d 1553, 1559 (11th Cir. 1985) (following the same standard). In this case, such facts would be those that inform the Government that an OCS lessee has underpaid royalties; the precise amount due need not be ascertained: "Uncertainty as to the exact amount of the Government's . . . (damages) does not constitute lack of knowledge of a fact 'material to the right of action.'" *United States v. Gavilan Joint Community College Dist.*, 849 F.2d at 1249.

Under FOGRMA's scheme, as well as in the case at bar, the Government need not complete its audits to discern the essence of its causes of action. In this case, in particular, there is no dispute that the leases at issue were conventional in the field; that Phillips and ARCO timely paid royalties; and that they timely submitted records to the MMS. Likewise, based on the record and the parties' representations, the audits involved were not problematic. *See, e.g.*, A.R., Vol. III, No. 11 (noting, in audit report, that lessee "was generally doing a good job in reporting and paying its royalties"). There is no evidence of delay on the part of the lessees or impeding complications surrounding the leases. *See, e.g., supra* note 3 (identify-

ing leases at issue and noting that some were acquired through merger approved by the MMS).

The Government's burden seems especially tolerable with respect to Phillips. The MMS has a permanent audit office, manned by four auditors, on site at Phillip's headquarters in Bartlesville, Oklahoma.[19] *See* Haugland Affidavit at ¶¶ 4-5. That office already conducts audits of Phillip's royalty payments "from time-to-time." *Id. at* ¶ 4.

To be sure, the MMS will need time to ascertain the details germane to any cause of action it might have. But, in the absence of summary judgment evidence to the contrary, the Court concludes that the six year limitations period affords the MMS ample time to investigate, verify, and choose the causes of action that it will pursue. As the MMS stated in responding to comments generated in the notice and comment process accompanying the promulgation of the most recent regulation addressing royalty valuation, *see infra* note 23, "MMS realizes that it must become increasingly familiar with transactions occurring in the areas where Federal and Indian leases are situated. By becoming more familiar and obtaining sales volume and price information, MMS will be able to identify anomalies that exist and review the circumstances involved in those transactions." 53 Fed. Reg. 1230 (Jan. 1988).

The Court holds that the Section 2415 six year period did not toll in this case. Holding otherwise would be manifestly unfair to the lessees. Therefore, the statute of limitations bars the Government from

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[19] There is no evidence, one way or the other, regarding an MMS audit office located on site with ARCO.

bringing any causes of action against Phillips and ARCO based on royalty payments on the leases at issue here that are due and owing for more than six years.[20]

## IV. MMS's Authority to Order Royalty Recalculations

The MMS orders notified Phillips and ARCO that they had wrongly calculated royalties on the OCS leases and ordered them to review their calculations and recalculate the royalties due using procedures outlined in the Procedure Paper. *See* A.R., Vol. I, No.'s 5, 6; Vol. II, No. 5; Vol. III, No. 1; Vol. VI, No.'s 1, 2, 3. Phillips and ARCO argue that the MMS has no authority to order such recalculations because they amount to "self-audits," which are prohibited by FOGRMA. The Government maintains that, when the MMS discovers a systemic error in a lessee's royalty payment procedures, such as the use of wrong royalty formulas, through an audit, the agency has authority to require lessees to review their records, account for royalties due, and make correct royalty payments. Such requirements, says the Government, do not amount to a self-audit.

Section 101 of FOGRMA provides that,

> (t)he Secretary shall audit and reconcile, to the extent practicable, all current and past lease accounts for leases of oil or gas and take ap-

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[20] The Court notes that the United States District-Court for the Northern District of Oklahoma recently reached similar conclusions regarding virtually identical statute of limitations issues. *See Atlantic Richfield Co. v. Lujan,* No. 89-C-892-B (N.D. Okla. filed September 9, 1992).

> propriate actions to make additional collections or refunds as warranted. The Secretary shall conduct audits and reconciliations of lease accounts in conformity with the business practices and recordkeeping systems which were required of the lessee by the Secretary for the period covered by the audit. . . . The Secretary may also audit accounts and records of selected lessees and operators.

30 U.S.C.A. § 1711(c)(1) (West 1986). Phillips and ARCO suggest that the plain language of this provision dictates that only the Secretary—that is, the DOI, itself—may audit lease accounts, meaning that self-audits are prohibited. The Government counters that no self-audits are involved and that the Secretary is simply taking appropriate collection actions pursuant to Section 101.

The Secretary, through the MMS, already has conducted sample audits in this case, finding what it considered to be systemic errors, and the MMS's orders identify those errors, which serve as the bases for the recalculations ordered.[21] As the Government notes,

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[21] This approach is entirely consistent with the legislative history behind Section 101, which states that the section,

> directs the Secretary to audit and reconcile all lease accounts or accounting line items and to take appropriate actions to make additional collections or refunds as warranted. The Secretary is authorized to select lease or payor accounts for audit on his own initiative—since auditing every account on an annual basis is clearly impractical—but the Committee intends that the Secretary will establish the means whereby all major accounts will be audited, at lease (sic) in whole or in part, annually

the MMS orders simply require Phillips and ARCO to correct the errors in their royalty calculation formulas already identified and to recalculate royalties based on the correct formulas; Phillips and ARCO are not asked to discover whether the same or any other royalty calculation formulas are in error. Such orders plainly fall within the scope of the Section 101's authorization to "take appropriate actions to make additional collections or refunds as warranted."

Further authority for the orders is found in Section 107 of FOGRMA. It provides that,

> In carrying out his duties under this chapter the Secretary may conduct any investigation or other inquiry necessary and appropriate and may conduct, after notice, any hearing or audit, necessary and appropriate to carrying out his duties under this chapter. In connection with any such hearings, inquiry, investigation, or audit, the Secretary is also authorized where reasonably necessary—
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> (1) to require by special or general order, any person to submit in writing such affidavits and answers to questions as the Secretary may reasonably prescribe, which submission shall be made within such reasonable period and under oath or otherwise, as may be necessary . . . .

30 U.S.C.A. § 1717(a) (West 1986). The legislative history behind this provision explains that, "(t)he

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and other accounts to the extend (sic) that the Secretary determines is suificient.

H.R. 97-859, 97th Cong., 2d Sess., *reprinted in* 1982 U.S.C. C.A.N. 4268, 4287.

Committee intended that the Secretary have broad enforcement authority relating to his royalty and lease management functions." H.R. 97-859, 97th Cong. 2d Sess., *reprinted in* 1982 U.S.C.C.A.N. 4268, 4286.

In addition, as the Court already has noted, Congress instructed that the Secretary "ensure the prompt and proper collection and disbursement of oil and gas revenues" with respect to all OCS leases. 30 U.S.C.A. § 1701(b)(3) (West 1986). Requiring the MMS to conduct all royalty calculations needed to correct systemic errors discovered in MMS audits of OCS leases, as the logical extension of Phillips and ARCO's position would have the Court do, would defeat this fundamental FOGRMA purpose in every meaningful respect.

Almost identical self-audit arguments were presented to the Tenth Circuit in *Phillips Petroleum Company v. Lujan*, 963 F.2d 1380 (1992) ("Phillips II"). There, Phillips and ARCO sought declaratory relief against the same defendants identified in this case, challenging MMS orders requiring Phillips and ARCO to retain oil and gas lease records for the period October 1, 1983, through September 30, 1989, and initiating company-wide audits "of the propriety of the royalty and other payments made by Phillips (and ARCO) . . . ." during the same period. *Id.* at 1382. Phillips argued that the company-wide audit would require it to audit its own records once one of its accounting procedures had been deemed erroneous.

The district court rejected this and Phillips and ARCO's other challenges, awarding summary judgment to the defendants. *Id.* at 1383. The Tenth Cir-

cuit affirmed, concluding that evidence of the company-wide audit procedures "clearly indicates that the MMS will ask Phillips and other lessees to make changes to correct repeated royalty underpayments caused by systemic deficiencies" and that, "(s)uch a request falls squarely within the purposes of FOGRMA." [22] *Id.* at 1386.

The recalculations ordered in this case differ in no meaningful respect from those ordered in *Phillips II*. The Tenth Circuit's rationale therein applies with equal force to this case. *See also Amoco Prod. Co.*, 123 IBLA 278, 284-85 (June 18, 1992) (rejecting same self-audit arguments urged by Amoco Production Co.).

There is no genuine issue of fact material to the "self-audit" arguments; that the MMS has authority to order recalculations once a systemic error has been identified is clear.

With the Government's authority to order recalculations of the type at issue herein established, the question becomes whether the recalculations ordered in this case were proper. Thus, the Court turns to Phillips and ARCO's contention that the Government's royalty valuations were invalid.

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[22] Phillips and ARCO also presented in *Phillips II* the same statute of limitations arguments they urge herein. Relying on its opinion in *Phillips I*, the Tenth Circuit rejected those arguments with respect to the MMS's order to retain records. *See* 963 F.2d at 1386. The court did not reach the statute of limitations arguments as they concerned the order initiating audit procedures.

## V. The Government's Royalty Valuations

The authority to determine royalties owed on production from OCS leases rests with the DOI. The royalties due in this case depend on the value assigned to production, and the Director of the MMS is responsible for determining that value.[23] *See* 30 C.F.R § 206.150 (1987). Contrary to ARCO's assertions, there is no burden on the MMS to determine that the lessee's valuations are unfair or unreasonable before imposing its valuations on the lessee. *See Mesa Operating Ltd. Partnership v. United States Dep't of the Interior*, 931 F.2d 318, 323 (5th Cir. 1991), *cert. denied*, 112 S. Ct. 934 (1992); *see also* 30 C.F.R. § 206.150 (1987) (outlining Secretary of the Interior's valuation authority).

The valuations at issue here were governed by DOI regulation "Section 206.150" [24] which, at the time of the MMS Orders, read as follows:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) the highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price

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[23] The leases at issue in this case, with the exception of the Phillips's "section 6" lease, echo the DOI's right to calculate production value. *See* Haugland Affidavit at Exhibits A, B, C. The section 6 lease is silent on the issue. *See id.* at Exhibit D. That silence, however, does not impede the DOI's express regulatory authority.

[24] The MMS has since revised its gas royalty valuation regulations. The latest version, 30 C.F.R. § 206.153 (1991), became effective March 1, 1988. *See* 53 Fed. Reg. 1230 (1988).

> received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

30 C.F.R. § 206.150 (1987). In this case, the MMS cited Section 206.150 when ordering Phillips and ARCO to recalculate royalties. In addition, the MMS orders looked to the Procedure Paper, a document issued by the Royalty Valuation and Standards Division of the Royalty Compliance Division of the MMS on December 14, 1984, modified by the MMS on February 25, 1985, and modified by the IBLA in *Conoco, Inc., and ARCO Oil and Gas Co.*, 110 IBLA 232 (August 29, 1989) (*"Conoco"*). The Procedure Paper purports to set forth a "yardstick valuation technique" to assist applications of Section 206.150. A.R., Vol. IV, No. 19, Attachment 1, unnumbered p. 2.

Phillips and ARCO now argue that one guideline set forth in the Procedure Paper, summarized by Phillips as "the published spot price in a particular commercial bulletin for a particular location," Phillip's Brief in Response at 16, became the MMS's sole consideration in valuing production, and hence, that the MMS failed to properly consider all of the valuation factors set forth in Section 206.150. Further, the MMS's use of the Procedure Paper, say Phillips and ARCO, amounted to rulemaking in violation of the notice and comment requirements of the Administrative Procedure Act ("APA"), 5 U.S.C.A. §§ 551-59 (West 1977 & Supp. 1992). In addition, to the ex-

tent that it approves the Procedure Paper, ARCO asks this Court to set aside the IBLA's *Conoco* decision.

In the alternative, Phillips and ARCO contend that the DOI failed to publish the Procedure Paper in the *Federal Register* pursuant to the APA's requirement that all substantive rules of general applicability and statements of general policy be so published, and that the application of the paper in this case violated other prohibitions against retroactive agency action.

Phillips and ARCO's first set of arguments boils down to two issues: a.) the validity of the MMS's production valuations; and b.) the impact of the APA's rulemaking requirements on the Procedure Paper. Because the second issue affects the first, the Court begins its inquiry there.

*Notice and Comment Rulemaking and the Procedure Paper*

Section 553 [25] of the APA requires that an agency promulgating a rule afford the public opportunity to have input into the rulemaking process by giving general notice of the proposed rule in the *Federal Register* and providing interested persons a chance to comment on the rule. *See* 5 U.S.C.A. § 553(b), (c), (d) (West 1977); *Batterton v. Marshall*, 648 F.2d 694, 711 (D.C. Cir. 1980). In this case, it is undisputed that these procedures were not followed; the Government argues simply that the Procedure Paper does not constitute a rule for APA purposes, and, therefore, is not subject to the APA's rulemaking requirements.

The APA defines a rule as,

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[25] Meaning the section number as codified in Title 5 of the United States Code.

> the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency and includes the approval or prescription for the future of rates, wages, corporate or financial structures or reorganizations thereof, prices, facilities, appliances, services, or allowances therefor *or of valuations, costs, or accounting, or practices bearing on any of the foregoing* . . . .

5 U.S.C.A. § 551(4) (West 1977) (emphasis added). Whether an agency's promulgation constitutes a rule is a matter of the item's substance and not the label given to it by the agency. *United States Dep't of Labor v. Kast Meals Corp.*, 744 F.2d 1145, 1149 (5th Cir. 1984) (citations omitted).

Consequently, for the purposes of this case, the Procedure Paper's "yardstick" terminology, by itself, has no effect. Rather, what is significant is that the Procedure Paper directly influences the valuation of NGLP's; whether it contains simple guidelines, descriptions, procedures, or binding dictates, the Procedure Paper qualifies as a rule under the APA's general definition.

That is not to say, however, that the paper is subject to the APA's notice and comment requirements. Indeed, exempted from those requirements are "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice." 5 U.S.C.A. § 553(b)(A) (West 1977).

The Procedure Paper, on its face, appears to fall under this exemption as either interpretive or pro-

cedural.[26] Courts have characterized those rules that merit notice and comment procedures as "substantive" rules, *see American Trucking Ass'n, Inc. v. United States*, 688 F.2d 1337, 1351 (11th Cir. 1982), *rev'd on other grounds*, 467 U.S. 354 (1984), and the distinction between substantive and interpretive rules beckons the Court here.

The distinction was a genesis of *Conoco*, a case in which ARCO and Conoco, Inc., challenged the Procedure Paper with the same arguments presented here. There, the IBLA concluded that the paper was not a substantive rule subject to the APA's notice and comment requirements, reasoning as follows:

> Substantive rules have the force of law where they constitute a substantive modification of an existing regulation, adoption of a new regulation, or a change in policy. The Procedure Paper merely clarified the existing regulations by setting forth a yardstick by which MMS would measure the reasonableness of royalty values reported by lessees. It did not require lessees to value their production by any specific method, nor did it modify any existing regulation. Rather, it found that, after consideration of the reasonable value of NGLP (nautral gas liquid product) in situations where no arm's-length contract existed was the commercially available

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[26] The distinction between interpretive and procedural rules has not been a burning issue for the courts. *See American Trucking Ass'n, Inc. v. United States*, 688 F.2d at 1351 (noting the difference and crediting the Fifth Circuit's *Brown Express, Inc. v. United States*, 607 F.2d 695, 702 [1979]); *see also Jean v. Nelson*, 711 F.2d 1455, 1479 (11th Cir. 1983) (summarizing *American Trucking*), *rev'd in part on other grounds*, 727 F.2d 957 (1984), *aff'd*, 472 U.S. 846 (1985).

> spot price bulletins. We find the Procedure Paper to be essentially a policy guideline adopted by MMS to assist in valuing NGLP production for royalty purposes under the provisions of the relevant regulation. As such, it does not have the force and effect of law as a duly promulgated regulation does, and the Board will decline to follow it where it is inconsistent with the terms of the relevant regulations.

110 IBLA at 242-43, A.R., Vol. IV, No. 1 (citations omitted). During its assessments of the valuations at issue in *Conoco*, the IBLA modified the Procedure Paper in one respect, stating that "we are unable to affirm the application of the Procedure Paper to the extent it is used to value NGLP production at a price in excess of the fair market value floor price . . . ." *Id.* at 244.

This Court may set aside the MMS's orders or the IBLA's determination to the extent that they or it wrongly apply the Procedure Paper if the Court finds that any of the actions were "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C.A. § 706(2) (West 1977). The Court "must consider whether the (agency's) decision was based on a consideration of relevant factors and whether there has been a clear error of judgment." *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971); *see Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-45 1984). Put another way, the Court may reject the order or the determination "only if the agency's interpretation is *impermissible* or *unreasonable*." *Mesa Operating, Ltd. Partnership v. United States Dep't of the Interior*, 931 F.2d at

323 (emphasis in original). Significantly, "(t)his standard is even more deferential where . . . a Court is reviewing an agency's application and interpretation of its own regulations." *Citizens for Fair Util. Regulations v. United States Nuclear Regulatory Comm'n*, 898 F.2d 51, 54 (5th Cir.) (citing *Robertson v. Methow Valley Citizens Council*, 490 U.S. 332 [1989]), *cert. denied*, 111 S. Ct. 246 (1990); *see Udall v. Tallman*, 380 U.S. 1, 16-17 (1965).

With this standard in mind, the Court conducts its substantive/interpretive rule analysis. Whether a rule is substantive or interpretive is a question of law for the Court. *Trinity Indus., Inc. v. Dole*, 760 F. Supp. 1194, 1198 (N.D. Tex 1991) (Belew, J.) (citing *Reeder v. FCC*, 865 F.2d 1298 [D.C. Cir. 1989]), *vacated on other grounds*, 963 F.2d 795 (5th Cir. 1992).

Substantive rules are "those that '*effect a change* in existing law or policy,' " *Mount Diablo Hosp. Dist. v. Bowen*, 860 F.2d 951, 956 (9th Cir. 1988) (emphasis in original), that is, those that are binding, *Western Coal Traffic League v. United States*, 694 F.2d 378, 392 (5th Cir. 1982), *cert. denied*, 466 U.S. 953 (1984), or have the force of law. *Ohio Dep't of Human Servs. v. United States Dep't of Human Servs., Health Care Financing Admin.*, 862 F.2d 1228, 1233 (6th Cir. 1988). An interpretive rule, undefined in the APA, is "merely a clarification or explanation of an existing statute or rule." *Id.* (quoting *Guardian Fed. Sav. & Loan Ass'n v. Federal Sav. & Loan Ins. Corp.*, 589 F.2d 658, 664 [D.C. Cir. 1978]). Interpretive rules "are not determinative of issues or rights addressed" and "do not . . . foreclose alternate courses of action or conclusively affect rights of private parties." *Batterton v. Mar-*

*shall*, 648 F.2d 694, 702 (D.C. Cir. 1980).[27]

The District of Columbia Circuit provided this oft-repeated insight:

> Generally speaking, it seems to be established that 'regulations,' 'substantive rules' or 'legislative rules' are those which create law, usually implementary to an existing law; whereas interpretative rules are statements as to what the administrative officer thinks the statute or regulation means.

*Cabais v. Egger*, 690 F.2d 234, 238 (1983) (quoting *Gibson Wine Co. v. Snyder*, 194 F.2d 329, 331 [D.C. Cir. 1952]); *see Brown Express, Inc. v. United States*, 607 F.2d at 701 (quoting the same language with approval); *Rivera v. Becerra*, 714 F.2d 887, 890-91 (9th Cir. 1983) (endorsing the *Cabais v. Egger* view), *cert. denied*, 465 U.S. 1099 (1984).[28]

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[27] The District of Columbia Circuit announced these conclusions with respect to all of the non-binding actions specified in 5 U.S.C.A. §§ 553(b)(3)(A), (d)(2) (West 1977). *See* 648 F.2d at 701. Therefore, the conclusions apply to each such action, individually. *See id.* at 701-02.

[28] Other definitional commentary is available. For example, in the words of the 1947 Attorney General's Manual on the APA, as quoted by the Fifth Circuit, interpretive rules are " 'rules or statements issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers.' " *Brown Express, Inc. v. United States*, 607 F.2d at 700. Similarly, the Ninth Circuit has presented this view:

> In determining whether a rule is interpretive or substantive, two factors must be considered. The first factor is whether the rule modifies existing rights, law, or policy. If the rule 'effect(s) a change in existing law or policy,' or ' "affect(s) individual rights and obligations," ' the

Whether a rule is substantive or interpretive is a matter of its substance and application; labels or phraseology used in the rule's text are not dispositive, and can be misleading. *See United States Dep't of Labor v. Kast Metals Corp.*, 744 F.2d at 1149; *American Trucking Ass'ns, Inc. v. I.C.C.*, 659 F.2d at 463; *Pharmaceutical Mfrs Ass'n v. Finch*, 307 F. Supp. 858, 863 (D. Del. 1970). Therefore, for resolution in the present case, the Court looks to both the substance, and the application, of the Procedure Paper.

The substance of the Procedure Paper is instructive. To begin, the paper explains its purpose as follows:

> Recent reviews of gas plants by the Royalty Compliance Division and the Office of Inspector General have raised questions regarding the appropriate method of valuing natural gas liquid products (NGLP's) extracted from gas produced on Federal and/or Indian lands. This valuation problem is particularly prevalent in cases where NGLP's have been transferred internally between affiliated entities.
>
> MMS regulations require the Secretary to establish a basis for computing royalties using

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rule is substantive. If the rule is only indicative of the agency's interpretation of existing law or policy, it is interpretive.

Second, the source of the rule must be considered. If it is promulgated pursuant to statutory authority, it is a substantive rule. If the agency does not exercise delegated legislative power to promulgate the rule, it is interpretive.

*W.C. v. Bowen*, 807 F.2d 1502, 1504 (1987) (citations omitted), *opinion amended and reh'g denied*, 819 F.2d 237 (1987).

> a reasonable unit value. *This value should never be less than the fair market value as determined by guidelines established by the Secretary.* At a minimum, royalties must be paid on the gross proceeds accruing to the lessee.
>
> *The purpose of this paper is to develop a 'yardstick' valuation technique for determining the reasonableness of a lessee's NGLP prices.*

A.R. Vol. IV, No. 19, Attachment 1, unnumbered p. 2 (footnote omitted, emphasis added).

The Procedure Paper further states that,

> in an effort to develop a yardstick . . .*the following sources were considered*:
>
> - *NGLP sales contracts*
> - *Prices received by lessees*
> - *Table 7 (DOE) prices*
> - *Commercially Available NGLP Bulletins*
>
> *A study of these sources* concluded that commercial price bulletins represent the best available price source and in most instances are indicative of NGLP fair market value.

*Id.* at unnumbered p. 4 (emphasis added).

The foregoing provisions are dispositive. They establish that the Procedure Paper is governed by Section 206.150 and that the paper's guidelines are driven by the regulation's core dictate that production value should never be less than fair market value. Further, while Phillips and ARCO contend that Section 206.150 requires the MMS to consider all five of the valuation factors set forth in its text, and the Court agrees, *see* 30 C.F.R. § 206.150 (1987) (providing that, "[i]n establishing the value, the

Director *shall consider* . . .") (emphasis added), the paper documents that the MMS has considered these factors in the form of NGLP sales contracts, prices received by lessees, Table 7 (DOE) prices, and commercially available NGLP bulletins. Moreover, while all five valuation factors need to be considered, it is inevitable that one factor ultimately may carry more weight than the others. The paper simply concludes that, after considering all five factors, one is more indicative of fair market value than the others.

The paper continues:

> To establish a yardstick to compare to the lessee's reported prices, MMS will take the highest and lowest published prices for the month from the appropriate bulletin. If the reported price falls within this range, the value will normally be accepted by MMS for royalty determination purposes. . . . If the prices used to calculate royalties fall below this range, a minimum value that is acceptable to MMS can be determined by developing an average value from the lowest and highest prices in the range.

*Id.* at unnumbered pp. 4-5.

This provision and others that follow document that the price received by the lessee is considered and receives a great deal of deference in the paper's recommendations. The paper also includes a Table of Price Sources that offers "suggested locations" for obtaining NGLP price sources for different producing areas in the United States, stressing with respect to those locations that, "each valuation case should be separately evaluated to determine if an alternate location would be more pertinent than the suggested loca-

tion." *Id.* at Procedure Paper Attachment 1 (unnumbered p. 10). In effect, the paper creates a list of sources to be consulted for "spot prices," which are equivalent to the Section 206.150 valuation factor, "posted prices."[29] The location variable is just one of the paper's several indications that Section 206.150's "other relevant factors" were not ignored.

In addition, that the paper interprets Section 206.150's fair market value is evidenced in its distinction between arm's-length and non-arm's-length contract situations. The pertinent portion of the paper reads as follows:

> (a) Arm's-length contracts
>
> *(From January 1980 to present)*
>
> If lessees have a true arm's length contract which establishes an NGLP price, MMS will normally accept the arm's length contract price for royalty purposes unless the gross proceeds received were higher than the contract price. For computation purposes, MMS will accept the greater of the arm's length contract price or gross proceeds.
>
> *(From 1973 to January 1980)*
>
> If the lessee received a maximum permissible price under the DOE regulations which was less than the contract price, the maximum permissible price becomes the fair market value to use for royalty computation purposes. Otherwise, con-

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[29] The Court accepts the Government's representation that a spot price is a type of posted price, and the Procedure Paper seems to indicate the same.

tract prices or gross proceeds are considered fair market value.

(b) Non-arm's-length contracts/No contract

*(From January 1980 to present)*

If lessees have a non-arm's-length contract which establishes an NGLP price *and* the lessee can demonstrate that the contract has characteristics similar to arm's-length contracts which represent fair market value, MMS will accept the non-arm's-length contract price for royalty computation purposes. If there are no arm's-length contracts for the same field or area, or the non-arm's-length contract does not represent fair market value, the yardstick value is considered fair market value.

*(From 1973 to January 1980)*

If the lessee received a maximum permissible price under the DOE regulations which was less than the yardstick price, the maximum permissible price becomes the fair market value to use for royalty computation purposes. Otherwise, yardstick prices or gross proceeds are considered fair market value.

A.R., Vol. III, No. 1 (emphasis in original).

From beginning to end, the Procedure Paper strives to explain what generally constitutes "fair market value" in certain circumstances; it falls well short of effecting a change in existing law or policy. Based on the manner in which the paper sets valuation ranges, recommends location variables, and accounts for contract-based considerations, the paper truly

functions as a "yardstick"; it cannot be said to have the force of law.

The MMS's application of the Procedure Paper in the present case was likewise consistent with the paper's interpretive substance. With respect to each lease to which the Procedure Paper was applied, *see supra* p. 4 n.5, the MMS determined that Phillips and ARCO had failed to value production at fair market value and plainly documented that Section 206.150 was the source of its rulings. *See* A.R., Vol. III, No. 1; Vol. VI, No.'s 1, 2, 3. Based on that determination, the MMS ordered Phillips to recalculate royalties, repeating the Procedure Paper's yardstick guidelines as follows:

> For determining the reasonableness of NGLP values based on non-arm's-length transactions, the MMS policy is to apply procedures as set out in its Procedure Paper, as modified by *Conoco Inc., ARCO Oil and Gas Co.*, 110 IBLA 232 (1989). The Procedure Paper now provides that if the NGLP's were disposed under non-arm's-length transactions, including transfers to affiliates, the unit values will be compared to the lowest prices published in commercial bulletins. If the value falls below the low price, it is considered unreasonable and unacceptable, and a value using the low price is used. Such values will be used for deriving a manufacturing allowance *and* for calculating royalties.

A.R., Vol. III, No. 1 (emphasis in original). The letter to ARCO likewise stated that, "(f)or determining the reasonableness of NGLP values for non-arm's-length arrangements, the MMS policy is to apply procedures as set out in the NGLP Paper as modified in

IBLA decision 87-762, 88-56, decided August 29, 1989." A.R., Vol. VI, No. 1 (emphasis added). In considering the leases at issue in each case, the MMS concluded, pursuant to the Procedure Paper, that spot market prices were a reasonable indicator of value and assessed royalties based on the Mont Belvieu, Texas, spot price. *See id.*; A.R., Vol. III, No. 1.

These orders demonstrate that the Procedure Paper was applied as a vehicle to aid assessments of Section 206.150's fair market value; as with the substance of the paper, its application does not effect a change in Section 206.150 or other existing law or policy. Additionally, the fact that the MMS uses the yardstick price ranges recommended in the paper does not make the paper, itself, binding.

Alternatively, the Court considers the Procedure Paper as a procedural rule under the APA.[30] The test

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[30] Under the APA, there is no definition of procedural rules. In the context of its substantial impact test, the Fifth Circuit noted only that "procedure" is the opposite of "substance." *Brown Express, Inc. v. United States,* 807 F.2d at 701. Black's Law Dictionary defines "procedure" as "the mode of proceeding by which a legal right by which a legal right is enforced, as distinguished from the substantive law which gives or defines the right, and which, by means of the proceeding, the court is to administer; the machinery, as distinguished from its product. That which regulates the formal steps in an action or other judicial proceeding . . . ." Black's Law Dictionary 1083 (5th ed. 1987). Beyond these basic principles, the Court sees no reason to attempt a rigid distinction between procedural and interpretive rules under the APA. Indeed, in most cases, courts have failed to acknowledge distinctions among the APA Section 553(b)(A) exemptions. *See American Trucking Ass'n, Inc. v. United States,* 688 F.2d at 1351; *supra* note 26.

in the Fifth Circuit for the APA's procedural rule exemption is as follows: The exemption does not apply to any proposed regulation that departs from existing practice and has a "substantial impact" on a "regulated industry, or an important class of members or the products of that industry." *Brown Express, Inc. v. United States*, 607 F.2d at 702 (quoting *Pharmaceutical Mfrs Ass'n v. Finch*, 307 F. Supp. 858, 863 [D. Del 1970]); *see also United States Dep't of Labor v. Kast Metals Corp.*, 744 F.2d at 1156 (discussing "the twin prongs of departure and substantial impact"). As the Fifth Circuit later explained,

> (i)n essence, the substantial impact test is the primary means by which courts look beyond the label 'procedural' to determine whether a rule is of the type Congress thought appropriate for public participation. An agency rule that modifies substantive rights and interests can only be nominally procedural, and the exemption for such rules of agency procedure cannot apply.

*United States Dep't of Labor v. Kast Metals Corp.*, 744 F.2d at 1153 (citations and footnote omitted).[31]

In the present case, the Court already has held that the Procedure Paper departs not from the existing

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[31] Although the substantial impact test has been criticized elsewhere, *see, e.g., American Transfer & Storage Co. v. Interstate Commerce Comm'n*, 719 F.2d 1283, 1285 n.4 (5th Cir. 1983) (summarizing criticisms of the test); *United States Dep't of Labor v. Kast Metals Corp.*, 744 F.2d at 1154 n. 19 (rejecting the Ninth Circuit's criticisms of the test and noting that the District of Columbia Circuit, while also criticizing it, employs the test), it remains the standard in the Fifth Circuit.

Section 206.150 practice.[32] *See supra* pp. 36-41. Additionally, there is no evidence that the paper has had a substantial impact on the OCS lease market and OCS lessees; Section 206.150's fair market value has been controlling production valuations all along, and the paper simply clarifies its meaning. In the parlance of the Fifth Circuit, any substantial impact of the paper is "purely derivative." *United States Dep't of Labor v. Kast Metals Corp.*, 744 F.2d at 1156.[33]

The Court concludes that the IBLA did not abuse its discretion, as outlined in the APA, 5 U.S.C.A. § 706(2) (West 1977), when it determined that the Procedure Paper was an interpretive rule not subject to the APA's notice and comment requirements in *Conoco, Inc., and ARCO Oil and Gas Co.*, 110 IBLA 232 (August 29, 1989). The IBLA's determination was not unreasonable, *see Mesa Operating, Ltd. Partnership v. United States Dep't of the Interior*, 931 F.2d at 323, by either of two independent analyses:

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[32] The Court, of course, understands that this practice necessarily must be shrinking because Section 206.150, per se, has been superseded by the March 1, 1988 production valuation regulations. *See* 30 C.F.R. § 206.153 (1991); *supra* note 24.

[33] Phillips also posits that the MMS's failure to give it notice of "the new standard for computing royalties on NGLP's set forth in the Procedure Paper," Phillips's Brief in Support of its Cross-Motion for Partial Summary Judgment at 52, violated Phillips's substantive and procedural due process rights. This argument fails because it is contingent on the existence of a right to notice and opportunity to comment in some form. Phillips has failed to establish such a right. Any rights that Phillips did have were satisfied when the MMS followed Section 206.150.

The paper is interpretive in substance and application, and, in light of its consistent obedience to Section 206.150, the paper, itself, is not the source of any substantial impact on the OCS leasing industry and OCS lessees.

The Procedure Paper was not subject to the APA's notice and comment rulemaking requirements. There is no genuine issue of material fact to the contrary.

*Section 552* [34] *of the APA*

Phillips's next contention is that the Procedure Paper should have been published in the *Federal Register* pursuant to Section 552 of the APA.

Apart from the APA's notice and comment requirements, Section 552 commands that an agency publish in the *Federal Register* "substantive rules of general applicability adopted as authorized by law, and statements of general policy or interpretations of general applicability formulated and adopted by the agency." 5 U.S.C.A. § 552 (West 1977). It further provides that, "(e)xcept to the extent that a person has actual and timely notice of the terms thereof, a person may not in any manner be required to resort to, or be adversely affected by, a matter required to be published in the Federal Register and not so published." *Id.* In other words, the Section 552 "requirement for publication attaches only to matters which if not published would adversely affect a member of the public." *United States v. Goodman*, 605 F.2d 870, 887-88 (5th Cir. 1979) (quoting *Hogg v. United States*, 428 F.2d 274, 280 [6th Cir. 1970], *cert. denied*, 401 U.S. 910 [1971]). It is undisputed that Phillips (and ARCO)

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[34] Meaning the section number as codified in Title 5 of the United States Code. *See also supra* note 23.

had no actual notice of the Procedure Paper until it was applied in this case.

The Court already has held that the Procedure Paper is not a substantive rule for Section 553's notice and comment rulemaking purposes, and that holding applies with equal force under Section 552. *See Brecker v. Queens B'Nai B'Rith Housing Dev. Fund Co.*, 798 F.2d 52, 56-57 (2d Cir. 1986); *McKenzie v. Bowen*, 787 F.2d 1216, 1222-23 (8th Cir. 1986). Therefore, the paper does not have the type of effect on the public contemplated by Section 552. Allowing Section 552's requirements to kick in for anything less than a substantive rule would require publication of a potentially limitless list of agency procedures, statements, and actions.

Courts have recognized this limit. In *Chevron Oil Co. v. Andrus*, 588 F.2d 1383 (5th Cir.), *reh'g denied*, 591 F.2d 1343, *cert. denied*, 444 U.S. 879 (1979), for example, a regional manager in the Bureau of Land Management of the DOI accepted Chevron's bids on some oil leases. Later, however, the Deputy Under Secretary of the Interior rejected the bids. *Id.* at 1384. The DOI claimed that it was not bound by the regional manager's acceptance because, in part, of a provision in its internal manual that provided that, "'(a)n officer who delegates or redelegates authority does not divest himself of the power to exercise that authority.'" *Id.* at 1388 (quoting 200 Departmental Manual § 1.3 [1970]). The manual had not been published in the *Federal Register*.

The Fifth Circuit ruled that the Manual's provision was binding and afforded the Under Secretary authority to overrule the regional manager. *Id.* at 1388-89. The Court reasoned that,

> it has been held that (section 552's) 'requirement for publication attaches only to matters which if not published would adversely affect a member of the public,' or which affect the steps a party must take to present a matter to an agency. The provision in the Interior's manual does not relate to the manner in which bids must be submitted. Nor was Chevron adversely affected by its nonpublication. We do not believe that knowing that the Secretary could participate in a decision to reject a bid would have induced Chevron to bid more than it did, and only a higher bid would have influenced the Deputy Under Secretary's decision.

*Id.* at 1388 n. 8 (quoting *Hogg v. United States*, 428 F.2d at 280) (citation omitted). Similarly, in *Hogg v. United States*, the Sixth Circuit held that, "the Administrative Procedure Act does not require that all internal delegations of authority from the Attorney General must be published in order to be effective." 428 F.2d at 280.

In *McKenzie v. Bowen*, the Secretary of Health and Human Services promulgated a method for calculating retroactive social security disability benefits in a program manual but did not publish the method in the *Federal Register*. 787 F.2d at 1217, 1220. Consequently, the district court enjoined the secretary from calculating benefits pursuant to the program manual method. The Eighth Circuit reversed, ruling that the method need not be published in the *Federal Register* because it was interpretive, rather than substantive.[35] *Id.* at 122-23.

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[35] As a second rationale for the injunction, the district court reckoned that the retroactive benefits calculation method was

In this case, the impact on royalties felt by Phillips (and ARCO) has been caused by the royalty valuation regulation, itself, Section 206.150, and not by the Procedure Paper's interpretation of it. Furthermore, the Procedure Paper does not change the "steps a party must take to present a matter to an agency." *Chevron Oil Co. v. Andrus*, 588 F.2d at 1388 n.8; *see supra* p. 46.

Though not pertinent for Section 552 purposes, at first blush, it appears that notice of the paper may have influenced Phillips's royalty calculations. If this were true to any meaningful extent, however, Phillips would not be pursuing the present consolidated cases. Phillip's only alternatives to the royalties assessed against it by the MMS are the royalties it actually paid. Those, of course, were considered by the MMS in reaching its determinations. *See* A.R., Vol. III, No. 1; Vol. VI, No.'s 1, 2, 3. There is no indication that the MMS would have calculated the royalties due any differently had it not used the Procedure Paper.

Phillips's Section 552 arguments are without merit.

*Retroactive Application of the Procedure Paper*

Phillips and ARCO claim that application of the Procedure Paper in this case violated prohibitions against retroactive agency action. This position is contingent on finding that the paper was a substantive rule. The ban on retroactive agency action applies only to new agency rules and agency rules adopted in an adjudicative proceeding. *See Bowen v. Georgetown*

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promulgated in violation of the APA's notice and comment requirements. The Eighth Circuit rejected this rationale as well. *See* 787 F.2d at 122.

*Univ. Hosp.*, 488 U.S. 204, 208-209 (1988); *McDonald v. Watt*, 653 F.2d 1035, 1041-42 (5th Cir. Unit A 1981).

The Procedure Paper is neither such rule, and that which was being applied in the MMS orders at issue here was the already-existing Section 206.150. There was no retroactive application.

*Validity of the MMS's Production Valuations*

Lastly, the Court considers the remaining valuation issue: The validity of the MMS's production valuations with respect to the leases at issue in this case. Phillips and ARCO's challenges to the valuations rest on their views of the Procedure Paper.

When setting royalties, the Secretary of the Interior, and thus, the MMS, has a great deal of discretion in determining the value of NGLP production. *See Marathon Oil Co. v. United States*, 604 F. Supp. 1375, 1382 (D. Alaska 1985), *aff'd*, 807 F.2d 759 (9th Cir. 1986), *cert. denied*, 480 U.S. 940 (1987). More generally, in the words of the Fifth Circuit, "(w)e defer to an agency's interpretation of its governing statute and regulations, and affirm that interpretation if it has a reasonable basis in law." *Freightcor Servs., Inc. v. Vitro Packaging, Inc.*, 965 F.2d 1339, 1343 (1992).

Phillips and ARCO have failed to demonstrate that the valuations ordered in this case were unreasonable. There is neither a challenge to the fairness of the Mont Belvieu spot price nor any indication that it is an improper embodiment of the requirements of Section 206.150.

Independently, because the MMS ordered that all of the recalculations at issue be done pursuant to the Procedure Paper, the recalculation orders are on firm

footing; all of the MMS's orders were based on the paper and are permissible to the extent that they were so based.[36]

With respect to the MMS's valuations of production in this case, there is no showing of arbitrary or capricious acts and no showing of clear error in judgment. The MMS did not abuse its discretion in applying the Procedure Paper or in arriving at the valuations that it did.

## VI. Conclusion

Phillips's Cross-Motion for Partial Summary Judgment and ARCO's Motion for Summary Judgment are GRANTED with respect to the statute of limitations issues, and the Government's Motion for Partial Summary Judgment is DENIED with respect to the same issues.

Therefore, the Government is precluded from bringing any causes of action against Phillips and ARCO

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[36] Phillips also argues that the MMS has not complied with the Paperwork Reduction Act of 1980 ("PRA"), 44 U.S.C.A. §§ 3501-20 (West 1991 & Supp. 1992). The PRA requires that the Director of the Office of Management and Budget approve by issuing a control number the "collection of information" by an agency. *See id.* at § 3507. The MMS's orders requiring recalculation of royalties in this case contain no such numbers. As the Government notes, Phillips's argument amounts to an amended pleading and is, therefore, inappropriate pursuant Rule 15(a), Fed. R. Civ. P. Even were the argument allowed, it would fail. The PRA "does not apply to the collection of information . . . during the conduct of . . . an administrative action or investigation involving an agency against specific individuals or entities . . . ." 44 U.S.C.A. § 3518(c)(1) (West 1991). The MMS actions at issue here plainly qualify for this exemption.

based on royalty payments on the leases at issue here more than six years after the payments are due.

The Government's Motion for Partial Summary Judgment is GRANTED with respect to the Government's authority to order the royalty recalculations ordered by the MMS in this case. Phillips's Cross-Motion for Partial Summary Judgment and ARCO's Motion for Summary Judgment are DENIED with respect to the same issue.

The Government's Motion for Partial Summary Judgment is GRANTED with respect to the MMS's use of the Procedure Paper in the orders at issue in this case. Phillips's Cross-Motion for Partial Summary Judgment and ARCO's Motion for Summary Judgment are DENIED with respect to the same issue.

Therefore, the Court refuses to set aside the IBLA's decision in *Conoco, Inc., and ARCO Oil and Gas Co.*, 110 IBLA 232 (August 29, 1989).[37] This ruling also means that the Government is not precluded from employing the Procedure Paper in its royalty valuations or pursuing causes of action springing from Procedure Paper-based royalty valuations so long as such actions are not based on royalties due and owing for more than six years at the time the complaint is filed.

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[37] ARCO also requested an allowance from the IBLA for transportation of its NGLP from a processing plant in Louisiana to Mont Belvieu, Texas. *See* ARCO's Memorandum in Support of Motion for Summary Judgment, filed August 16, 1991, at 24-26. The IBLA denied the allowance. Because the MMS's Royalty Management Program has no record that any such transportation took place and because ARCO has made no showing that it did, the Court will not set aside the IBLA's denial of the transportation allowance.

All other requested relief not expressly addressed in this Memorandum Opinion and Order is DENIED.

SO ORDERED.

DATED: September 17, 1992.

/s/ Barefoot Sanders
BAREFOOT SANDERS
Chief Judge
United States District Court
Northern District of Texas

**APPENDIX E**

[DOI LOGO]

UNITED STATES DEPARTMENT
OF THE INTERIOR
MINERALS MANAGEMENT SERVICE
Dallas Area Complaint Office
8303 Elmbrook Drive, Suite 110
Dallas, Texas 75247

[Sep. 29, 1989]

*HAND DELIVERED*

ARCO Oil and Gas Company
Attention: Director, Royalty
Policy and Compliance, 37-116 DAB
Post Office Box 2819
Dallas, Texas 75221

Re: Disposition and Pricing of Offshore Natural Gas Liquid Products

Gentlemen:

The Minerals Management Service (MMS) has recently completed an audit of royalties paid by ARCO Oil and Gas Company (ARCO) pertaining to both offshore and onshore Federal and Indian leases. Our audit included a review of the natural gas liquid products (NGLP) extracted through the processing of gas at the Yscloskey Processing Plant (Yscloskey). The Department of the Interior, Office of Inspector General (OIG) previously audited the Grand Chenier Gas Processing Plant (Grand Chenier). The results of these audits are discussed below:

*Yscloskey Processing Plant*

We reviewed the natural gas liquid products (NGLP) extracted through the processing of gas at Yscloskey. The gas was produced during September 1983, on Outer Continental Shelf (OCS) leases 054-002919-0, 054-002636-0, 054-002637-0, 054-002640-0, and 054-004501-0. MMS took exception to the price ARCO used for the disposition of its butanes because it was not in accordance with MMS's NGLP Procedure Paper (NGLP Paper). MMS presented its findings to ARCO in letters dated September 6, 1989 and September 7, 1989.

*Grand Chenier Gas Processing Plant*

In a letter dated December 12, 1986, MMS presented ARCO with the results of the OIG audit of royalties paid by, or on behalf of, ARCO on natural gas liquid products produced from OCS leases, processed at Grand Chenier, for the period January 1977 through December 1981. MMS took exception to the price ARCO used for the disposition of the propane, butanes, and natural gasoline. The butanes and natural gasoline were exchanged, and the propane was commingled with other producers in the Dixie Pipeline. MMS in issuing its findings directed ARCO to use the audited manufacturing allowance for the two biennial periods ending September 1981 and adjust the royalty payments for the Grand Chenier lease production based upon the NGLP Paper unit prices. ARCO appealed the MMS order involving the Grand Chenier lease production. The Interior Board of Land Appeals, in IBLA decision 87-762, 88-56, decided on August 29, 1989, stated that the Secretary possesses considerable discretion in determining the value of production for royalty purposes.

The regulations at 30 CFR 206.150 (1984) state in part:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee. . . . Under no circumstances shall the value of production be less than gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

For the gas plants identified above, our review disclosed that ARCO has undervalued the plant products because the NGLP's were sold under non-arm's-length arrangements. Consequently, MMS considers a systemic or procedural deficiency to exist in the method used to calculate royalty.

Therefore, in order to correct the systemic deficiencies affecting the computation of royalty and to bring your royalty payments into compliance with 30 CFR 206.150, ARCO is directed to complete the requirements set forth in the following paragraphs:

1. Within 60 days of receipt of this letter, review the disposition of the NGLP's of all of its offshore leases, where gas is processed for the extraction of NGLP's, identifying the leases where product(s) were sold under non-arm's-length arrangements. The enclosed schedule should be used for the purpose of documenting its review. The leases

should be reviewed for the period October 1980 through February 1988. For leases processed at Grand Chenier, ARCO should review the period from October 1981 through February 1988. ARCO should exclude from its review, leases covered by MMS's letters dated September 6 and 7, 1989, which relate to the leases processed at the Ysclos-key Processing Plant.

2. Within 90 days of receipt of this letter, compute NGLP values for the period and gas plants identified pursuant to Item 1. For determining the reasonableness of NGLP values for non-arm's-length arrangements, the MMS policy is to apply procedures as set out in the NGLP Paper as modified in IBLA decision 87-762, 88-56, decided August 29, 1989. The NGLP Paper and the IBLA decision were previously provided to ARCO as attachments to the above referenced MMS letters.

3. Within 120 days of receipt of this letter, and for gas plants ARCO does not have an interest in, recalculate and pay any resulting royalty underpayment. Copies of revised 250.67 worksheets should be provided to the MMS Resident Audit Team.

4. Within 120 days of receipt of this letter, and for gas plants ARCO has an interest in, and for which the computations in Item 2 result in an increase in the NGLP value, compute annual liquid value and expenses for the period identified in Item 1. This information should be submitted to:

Minerals Management Service
Royalty Valuation and Standards Division
Post Office Box 25165, MS 653
Denver, Colorado 80225

Copies should be provided to the MMS Resident Audit Team.

4. Within 60 days of receipt of an approved plant-wide manufacturing allowance from MMS, recalculate royalties and pay any resulting underpayments.

Your payment should be made in accordance with the procedures outlined in 30 CFR 218.51, and the audit adjustments may be processed through the mechanized royalty reporting system using audit adjustment reason code 41 or 43. Appropriate late payment charges pursuant to 30 CFR 218.150 will be computed and billed upon receipt of payment of additional royalties due.

All supporting calculations and source documents are subject to audit by MMS, and therefore should be retained by ARCO until MMS completes its follow-up compliance testing. Our review of other aspects of volume and values on which royalty is based are not complete. When that portion of our audit is final, we will notify ARCO of any additional exceptions concerning royalty determinations and payments.

Section 109 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), promulgated in 30 CFR 241.57, authorizes MMS to assess civil penalties for failure or refusal to comply with the requirements of FOGRMA or any statute, regulation, rule, order or permit. Consequently, your failure to comply with the terms of this order may be considered a violation pursuant to 30 CFR 241.51(a)(3) and could subject you to penalties of up to $5,000 per violation.

You have the right to appeal in accordance with the provisions of 30 CFR 290. Any appeal taken will be to the Director, Minerals Management Service, and the notice of appeal must be filed with:

Nick L. Kelly, Area Manager
Dallas Area Compliance Office
Minerals Management Service
8303 Elmbrook Drive, Suite 110
Dallas, Texas 75247

within 30 days from the date of receipt of this letter.

The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of this directive. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. You may also request, pursuant to 30 CFR 290.4, to present oral argument or evidence to the Director, Minerals Management Service, and such motion should be filed with the Director who may, at his discretion, schedule a hearing at a time and place of his choosing.

With the exception of the time fixed for filing a notice of appeal, the time for filing any document in connection with an appeal may be extended by the Director, Minerals Management Service. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

In accordance with the provisions of 30 CFR 243.2 (1988), compliance with this order may be suspended upon the posting of an adequate surety in the form of a bond or letter of credit pending the outcome of

the appeal. Adequate surety will be based on the amount determined by developing a reasonable estimate of the amount due under the order, subject to approval of the undersigned. Your proposal of the amounts due under the order must be sent to the address indicated above and must be received within 30 days after receipt of this order. The approved surety amount will include principal plus interest projected one year in advance and will be furnished to you along with instructions for posting surety. Upon request by MMS, the amount of surety will be increased periodically, if necessary, to cover any additional interest that may accrue.

If you have any questions, contact Lonnie Kimball at (214) 767-7502.

Sincerely,

/s/ William E. Stanley
for NICK L. KELLY
Area Manager
Dallas Area Compliance Office

Enclosure

cc: Milton K. Dial, Chief
Royalty Valuation and
Standards Division

[DOI Logo]

UNITED STATES DEPARTMENT
OF THE INTERIOR
MINERALS MANAGEMENT SERVICE
Dallas Area Compliance Office
6126 E. 32nd Place
Tulsa, Oklahoma 74135

Sep. 27, 1989

*HAND DELIVERED*

Phillips Petroleum Company
Attention: Mr. S. M. Haugland
Senior Laws and Regulations Specialist
1090H Plaza Office Building
Bartlesville, Oklahoma 74004

Re: Gas Plants in Which Phillips Petroleum Company (Phillips) Had an Ownership Interest and Processed Gas Produced From Offshore Federal Leases From January 1977 through February 1988

Dear Mr. Haugland:

The United States Department of the Interior has completed audits of royalties paid by Aminoil Inc. (Aminoil) pertaining to offshore Federal leases. Specifically, the Office of Inspector General (OIG) conducted an audit of Aminoil's share of royalties paid on natural gas liquid products (NGLP's) for eight offshore Federal leases processed through the North Terrebonne Gas Processing Plant for the period January 1977 through December 1983. Phillips acquired the leases through the January 1, 1985, merger of Aminoil into Phillips. Aminoil based its NGLP roy-

alty prices on sales to Aminoil Marketing Incorporated, which was 50 percent owned by Aminoil. Royalties were understated as a result of valuing the NGLP's sold under non-arm's-length arrangements at less than the fair market value for royalty purposes. By letter dated January 28, 1986, Phillips was apprised of the preliminary underpayment of NGLP's royalties and voluntarily paid the additional royalties due through December 31, 1983.

By order dated April 17, 1986, Minerals Management Service (MMS) directed Phillips to review the royalty computations for Aminoil's share of the NGLP's produced at the North Terrebonne Gas Processing Plant for the period January 1984 through the present (February 1988) to assure that the royalty paid subsequent to the OIG audit was calculated using a market value which met the criteria set forth in the MMS Procedure Paper on Natural Gas Liquid Products Valuation (Procedure Paper) (Enclosure 1). Phillips appealed the order to the Director, Minerals Management Service, and subsequently appealed the Director's decision to the Interior Board of Land Appeals (IBLA). As of this date, the IBLA has not rendered a decision.

MMS has conducted a review of Phillips' share of NGLP's processed through the Rollover Gas Plant. The disposition of the NGLP's, except for ethane, were intercompany transfers or sales to affiliates which are considered as non-arm's-length transactions. The values used by Phillips did not consistently represent the fair market value for royalty purposes as outlined in the provisions of the Procedure Paper. The regulations at 30 CFR 206.150 (1987) state in part:

The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director.

The regulations at 30 CFR 206.152 (1987 state in part:

(a) When gas is processed for the recovery of constituent products, a royalty established by the terms of the lease will accrue on the value or amount of:

(1) All residue gas remaining after processing, and

(2) All natural gasoline, butane, propane, or other substances extracted from the gas. A reasonable allowance, determined by the Director and based upon regional plant practices and actual plant costs and other pertinent factors, may be made for the cost of processing and may be deducted from the royalty payment due on said constituent substances. However, the reasonable allowance shall not exceed two-thirds of the value of the substances extracted unless the Director determines that a greater allowance is in the national interest.

(b) Under no circumstances shall the amount of royalty on the residue gas and extracted substances be less than the amount which the Director determines would be payable if the gas had been sold without processing.

Based on the audits discussed herein and Phillip's responses thereto, the MMS considers a systemic or procedural deficiency to exist in the method used to calculate royalty due.

Accordingly, to correct the system deficiencies affecting the computation of royalty on production from offshore Federal leases, Phillips is directed to complete the requirements set forth in the following paragraphs:

1. Examine records of plant ownership and identify: (1) all offshore gas plans in which Phillips held an ownership interest from January 1977 through February 1988, and at which natural gas from Phillip's offshore Federal leases was processed; and (2) Phillips-owned offshore Federal leases which are associated with those plants and other plant owners leases for which Phillips pays royalties. This shall include all interests acquired through mergers with other entities. Phillips is to provide this information by completing Enclosure 2 and returning the information to the MMS Resident Audit Team within 60 days of receipt of this order.
2. Within 90 days of receipt of this order, compute NGLP values for the period January 1977 through February 1988 for each of the gas plants identified pursuant to Item 1. For determining the reasonableness of NGLP values based on non-arm's-length transactions, the MMS policy is to apply procedures as set out in its Procedure Paper as modified by *Conoco Inc., ARCO Oil and Gas Co.*, 110 IBLA 232 (1989). The Procedure Paper now provides that if the NGLP's were disposed under non-arm's-length transactions, including transfers to affiliates, the unit values will be compared to

the lowest prices published in commercial bulletins. If the value falls below the low price, it is considered unreasonable and unacceptable, and a value using the low price is used. Such values will be used for deriving a manufacturing allowance *and* for calculating royalties.

Copies of the computations will be provided to the MMS Resident Audit Team. Should the computations result in an increase in NGLP value, compliance with Items 3 and 4 will be required.

3. Within 120 days of receipt of this order, compute annual liquid value and expenses for the period January 1977 through February 1988 for each of the gas plants identified pursuant to Item 1 where the computations result in an increase in NGLP value. This information should be submitted to:

   Minerals Management Service
   Royalty Valuation and Standards Division
   Post Office Box 25165, MS 653
   Denver, Colorado 80225

Copies should be provided to the MMS Resident Audit Team. This order does not pertain to the North Terrebonne Natural Gas Processing Plant for the period January 1977 through February 1988. This plant, for the period specified, was addressed separately in the April 17, 1986 order.

4. Within 60 days of receipt of an approved plant-wide manufacturing allowance from MMS, recalculate royalties required by 30 CFR 206.152 and pay any resulting underpayments. Payment must be accompanied by properly completed green Report of Sales and Royalty Remittance (MMS-

2014) forms using adjustment reason code 41 or 43, as appropriate. Your payment should be made in accordance with procedures outlined in 30 CFR 218.51. Appropriate late payment charges pursuant to 30 CFR 218.150 will be computed and billed to Phillips upon receipt of payment of additional royalties due. A copy of any payment made and related green MMS-2014 forms filed as a result of this directive should be provided to the MMS Resident Audit Team.

All supporting calculations and source documents are subject to audit by MMS, and therefore should be retained by Phillips until MMS completes its follow-up compliance testing. Our review of the other aspects of volume and values on which royalty is based are not complete. When that portion of our audit is final, we will notify Phillips of any additional exceptions concerning royalty determinations and payments.

Section 109 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), promulgated in 30 CFR 241.51, authorizes MMS to assess civil penalties for failure or refusal to comply with the requirements of FOGRMA or any statute, regulation, rule, order, lease, or permit. Consequently, your failure to comply with the terms of this order may be considered a violation pursuant to 30 CFR 241.51 (a)(3) and could subject you to penalties of up to $5,000 per violation per day for each day such violation continues.

You have the right to appeal in accordance with the provisions of 30 CFR 290. Any appeal taken will be to the Director, Minerals Management Service, and the notice of appeal must be filed with:

Nick L. Kelly, Area Manager
Dallas Area Compliance Office
Minerals Management Service
8303 Elmbrook Drive, Suite 110
Dallas, Texas 75247

within 30 days from the date of receipt of this order.

The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of this directive. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. You may also request, pursuant to 30 CFR 290.4, to present oral argument or evidence to the Director, Minerals Management Service, and such motion should be filed with the Director who may, at his discretion, schedule a hearing at a time and place of his choosing.

With the exception of the time fixed for filing a notice of appeal, the time for filing any document in connection with an appeal may be extended by the Director, Minerals Management Service. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

In accordance with the provisions of 30 CFR 243.2 (1988), compliance with this order will be suspended upon the posting of an adequate surety in the form of a bond or letter of credit pending the outcome of the appeal. Adequate surety will be determined by developing a reasonable estimate of the amount due under the order, subject to the approval of the undersigned. Your proposal of the amount due under the

order must be sent to the address indicated above and must be received within 30 days after receipt of this order. The approved surety amount will include principal plus interest projected one year in advance and will be furnished to you along with instructions for posting surety. Upon request by MMS, the amount of surety will be increased periodically, if necessary, to cover any additional interest that may accrue.

If you have any questions concerning this order, contact Bob Rives at 918-581-6453.

Sincerely,

/s/ Ray M. Williams
for NICK L. KELLY
Area Manager
Dallas Area Compliance Office

3 Enclosures

cc: Milton K. Dial, Chief
Royalty Valuation and
Standards Division

[DOI Logo]

UNITED STATES DEPARTMENT
OF THE INTERIOR
MINERALS MANAGEMENT SERVICE
Dallas Area Compliance Office
8303 Elmbrook Drive, Suite 110
Dallas, Texas 75247

[Sep. 7, 1989]

*HAND DELIVERED*

ARCO Oil and Gas Company
Attention: Director, Royalty
Policy and Compliance, 37-116 DAB
1601 Bryan Street
Dallas, Texas 75201

Re: Natural Gas Liquid Products—Yscloskey Processing Plant

Gentlemen:

The Minerals Management Service (MMS), has recently completed an audit of royalties paid by ARCO Oil and Gas Company (ARCO) on certain Outer Continental Shelf leases. As part of our audit we reviewed the natural gas liquid products (NGLP) extracted through the processing of gas at the Yscloskey Processing Plant (Yscloskey). The MMS presented ARCO with a letter dated September 6, 1989, identifying pricing errors of NGLP's at Yscloskey. (See Enclosure 1).

The regulations at 30 CFR 206.150 (1984) state in part:

> Under no circumstances shall the value of production be less than the gross proceeds accruing

> to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

The regulations at 30 CFR 206.152(b) (1984) state:

> Under no circumstances shall the amount of royalty on the residue gas and extracted substances be less than the amount which the Director determines would be payable if the gas had been sold without processing.

In order to bring your royalty payments for Yscloskey lease production into compliance with 30 CFR 206.150 and 206.152, ARCO is directed to perform the following:

1. Identify all leases processed through Yscloskey beginning with sales month 9/83 through the current month. Recompute the NGLP's using the Mont. Belvieu, Texas, prices as provided by the procedures and IBLA decision 87-762, 88-56 both attached as Enclosure 2. Complete Enclosure 3 identifying: Sales Month, Lease Number, Wellhead Value, Processed Value, Plant Products Value (original), Plant Products Value (revised), Royalty Paid, Royalty Due, and Additional Royalty Due after the price recalculation. As long as conditions remain the same as in 9/83, ARCO would only have to adjust the butane unit prices.

2. Inform MMS of any changes to the contracts MMS used in its audit. These changes should include purchasers and/or disposition (sales, exchanges, transfers).

3. Pay any additional royalty due for sales months 9/83 through the current month.

Payment of calculated royalty deficiencies must be completed within 60 days from receipt of this letter. Copies of revised 250.67 worksheets should be provided to the Resident Audit Supervisor. Your payment should be made in accordance with the procedures outlined in 30 CFR 218.51 and the audit adjustments may be processed through the mechanized royalty reporting system using audit adjustment reason code 41. Appropriate late payment charges pursuant to 30 CFR 218.150 will be computed and billed upon receipt of payment of additional royalties due. If, in the future, we determine that the required accounting has not been done and future royalty payments do not comply with this order, the violation may be considered willful.

Section 109 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), promulgated in 30 CFR 241.51, authorizes MMS to assess civil penalties for failure or refusal to comply with the requirements of FOGRMA or any statute, regulation, rule, order or permit. Consequently, your failure to comply with the terms of this order may be considered a violation pursuant to 30 CFR 241.51 and could subject you to penalties of up to $5,000 per violation per day for each day such violation continues and up to $10,000 per violation each day if the violation is considered to be willful.

You have the right to appeal in accordance with the provisions of 30 CFR 290. Any appeal taken will be to the Director, Minerals Management Service, and the notice of appeal must be filed with:

Nick L. Kelly, Area Manager
Dallas Area Compliance Office
Minerals Management Service
8303 Elmbrook Drive, Suite 110
Dallas, Texas 75247

within 30 days from the date of receipt of this letter.

The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of this directive. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. You may also request, pursuant to 30 CFR 290.4, to present oral argument or evidence to the Director, Minerals Management Service, and such motion should be filed with the Director who may, at his discretion, schedule a hearing at a time and place of his choosing. With the exception of the time fixed for filing a notice of appeal, the time for filing any document in connection with an appeal may be extended by the Director, Minerals Management Service. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

In accordance with the provisions of 30 CFR 243.2, compliance with this order will be suspended upon the posting of an adequate surety in the form of a bond or letter of credit pending the outcome of the appeal. Adequate surety will be determined by developing a reasonable estimate of the amount due under the order, subject to the approval of the undersigned. Your proposal of the amount due under the order must be sent to the address indicated above and

must be received within 30 days after receipt of this letter. The approved surety amount will include principal plus interest projected one year in advance and will be furnished to you along with instructions for posting surety.

If you have any questions, contact Lonnie Kimball at (214) 767-7502.

Sincerely,

/s/ Nick L. Kelly
NICK L. KELLY
Area Manager
Dallas Area Compliance Office

Enclosures

[D OF I LOGO]

UNITED STATES DEPARTMENT
OF THE INTERIOR
MINERALS MANAGEMENT SERVICE
Dallas Area Compliance Office
8303 Elmbrook Drive, Suite 110
Dallas, Texas 75247

[Sep. 6, 1989]

*HAND DELIVERED*

ARCO Oil and Gas Company
Attention: Director, Royalty
Policy and Compliance, 37-116 DAB
1601 Bryan Street
Dallas, Texas 75201

Re: Natural Gas Liquid Products Valuation—Leases 054-002919-0, 054-002636-0, 054-002637-0, 054-002640-0, and 054-004501-0

Gentlemen:

The Minerals Management Service (MMS), has completed an audit of royalties paid by ARCO Oil and Gas Company (ARCO) for sales month 9/83 on the referenced Outer Continental Shelf leases. Our audit included a review of all products produced on the leases and the natural gas liquid products (NGLP) extracted through the processing of gas at the Yscloskey Processing Plant (Yscloskey). Royalty calculations on products processed through this plant were audited previously by the Department of the Interior, Office of Inspector General for the period January 1980 through December 1982. The results of our review are discussed below.

During the sales month of 9/83, ARCO based NGLP sales prices on both intracompany transfer prices and arm's-length sales prices. Based on the contracts provided, ARCO has arm's-length contracts for propane, ethane, and gasoline. The butanes are exchanged and are governed by a non-arm's-length agreement. The price received under a true arm's-length contract establishing an NGLP price, will normally be accepted for royalty purposes. For determining the reasonableness of the NGLP values for non-arm's-length sales, the MMS policy is to apply procedures as set out in its procedure paper on "Natural Gas Liquid Products Valuation" (Enclosure 1). Our review disclosed that certain prices reported by ARCO were less than those determined in accordance with MMS's NGLP valuation policy. Accordingly, we revalued the plant NGLP production for 9/83 using these procedures.

The procedures provide that if the NGLP's were disposed of under non-arm's-length transactions, including transfers to affiliates, the unit values will be compared to the lowest applicable price published in specified commercial bulletins. If the intracompany value is below the lowest published price, it is considered unacceptable for royalty purposes. The MMS calculated royalty on the lowest Mont Belvieu spot market prices for non-arm's-length transactions where the value used was less than the low Mont Belvieu spot market price as published in the Oil Buyer's Guide. Enclosure 2 is a schedule showing the pricing exceptions applicable to ARCO's NGLP production. The recalculation of NGLP's resulted in an increase in the amount of ARCO's lease valuation for liquid products by $64.16 in royalties on Lease 054-002919-0, however, because ARCO used an incorrect plant vol-

ume reduction (PVR) volume (volume for Ship Shoal Block 158C was used instead of Ship Shoal Block 91B), the wellhead method of reporting remained greater than plant products plus residue (Enclosure 3).

The audited leases comprising the Mississippi Canyon 148 Unit (MC 148), (054-002636-0, 054-002637-0, 054-002640-0, and 054-004501-0), are also being processed through Yscloskey. The disposition of the NGLP's allocated to these leases is identical to Lease 054-002919-0, i.e., butanes are not sold under an arm's-length contract. Using the revised established prices for butane and the recognized contract prices for ethane, propane, and gasoline, we recalculated the liquid products section for each lease in the MC 148 Unit. For these leases, the revised liquid products prices plus residue remained lower than wellhead for all four leases. ARCO based its royalty payment on the value of the wellhead gas which yielded a greater royalty.

The regulations at 30 CFR 206.150 (1984) state:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced

> substances or less than the value computed on the reasonable unit value established by the Secretary.

The regulations at 30 CFR 206.152(b) (1984) state:

> Under no circumstances shall the amount of royalty on the residue gas and extracted substances be less than the amount which the Director determines would be payable if the gas had been sold without processing.

In order to bring your royalty payments for production on the referenced Leases at Ysclosky into compliance with 30 CFR 206.150 and 206.152, ARCO is directed to perform the following:

1. Inform MMS of any changes to the contracts MMS used in its audit. These changes should include purchases and/or disposition (sales, exchanges, transfers).
2. Recalculate and pay any additional royalty due for sales months 10/83 through the current month, and continue thereafter, for Leases 054-002919-0, 054-002636-0, 054-002637-0, 054-002640-0, and 054-004501-0 using the NGLP Paper for pricing of NGLP's as modified by Interior Board of Lands Appeal Decision dated August 29, 1989 (Enclosure 4). As long as conditions remain the same as in 9/83, ARCO would only have to adjust the butane unit prices.
3. Recoup the overpayment for Lease 054-002919-0 before any additional royalty is paid.

Payment of calculated royalty deficiencies must be completed within 60 days from receipt of this letter. Copies of revised 250.67 worksheets should be pro-

vided to the Resident Audit Supervisor. Your payment should be made in accordance with the procedures outlined in 30 CFR 218.51 and the audit adjustments may be processed through the mechanized royalty reportings stem using audit adjustment reason code 41. Appropriate late payment charges pursuant to 30 CFR 218.150 will be computed and billed upon receipt of payment of additional royalties due. If, in the future, we determine that the required accounting has not been done and future royalty payments do not comply with this order, the violation may be considered willful.

Section 109 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), promulgated in 30 CFR 241.51, authorizes MMS to assess civil penalties for failure or refusal to comply with the requirements of FOGRMA or any statute, regulation, rule, order or permit. Consequently, your failure to comply with the terms of this order may be considered a violation pursuant to 30 CFR 241.51 and could subject you to penalties of up to $5,000 per violation per day for each day such violation continues and up to $10,000 per violation each day if the violation is considered to be willful.

You have the right to appeal in accordance with the provisions of 30 CFR 290. Any appeal taken will be to the Director, Minerals Management Service, and the notice of appeal must be filed with:

Nick L. Kelly, Area Manager
Dallas Area Compliance Office
Minerals Management Service
8303 Elmbrook Drive, Suite 110
Dallas, Texas 75247

within 30 days from the date of receipt of this letter.

The notice of appeal must be accompanied by a written showing, as you deem adequate, to justify reversal or modification of this directive. Within the same 30-day period, the appellant will be permitted to file additional statements of reason or written briefs. You may also request, pursuant to 30 CFR 290.4, to present oral argument or evidence to the Director, Minerals Management Service, and such motion should be filed with the Director who may, at his discretion, schedule a hearing at a time and place of his choosing.

With the exception of the time fixed for filing a notice of appeal, the time for filing any document in connection with an appeal may be extended by the Director, Minerals Management Service. Any request for an extension of time must be filed within the 30-day period allowed for filing of the appeal document and must be filed with the same office in which the appeal document was filed.

In accordance with the provisions of 30 CFR 243.2, compliance with this order will be suspended upon the posting of an adequate surety in the form of a bond or letter of credit pending the outcome of the appeal. Adequate surety will be determined by developing a reasonable estimate of the amount due under the order, subject to the approval of the undersigned. Your proposal of the amount due under the order must be sent to the address indicated above and must be received within 30 days after receipt of this letter. The approved surety amount will include principal plus interest projected one year in advance and will be furnished to you along with instructions for posting surety.

If you have any questions, contact Lonnie Kimball at (214) 767-7502.

Sincerely,

/s/ Nick L. Kelly
NICK L. KELLY
Area Manager
Dallas Area Compliance Office

4 Enclosures

**APPENDIX F**

[DOI Logo]

UNITED STATES DEPARTMENT
OF THE INTERIOR
OFFICE OF HEARINGS AND APPPEALS
INTERIOR BOARD OF LAND APPPEALS
4015 Wilson Boulevard
Arlington, Virginia 22203

CONOCO INC.
ARCO OIL AND GAS CO.

IBLA 87-762, 88-56 Decided August 29, 1989

Appeal from a decision of the Director, Minerals Management Service, affirming orders requiring payment of additional royalties on natural gas liquid products produced under Outer Continental Shelf oil and gas leases (MMS 86-0203-OCS), and appeal from a decision of the Acting Director, Minerals Management Service, affirming orders assessing late payment charges (MMS 86-0344-OCS).

Set aside and remanded.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties—Oil and Gas Leases: Royalties: Natural Gas Liquid Products—Outer Continental Shelf Lands Act: Oil and Gas Leases

   The valuation of natural gas liquid products for purposes of computing the royalty due is required by statute and regulation to be not less than the greater of the fair market value or the gross proceeds realized by the

lessee. One of the factors to be considered in assessing fair market value under the regulation governing royalty valuation is posted prices. A determination of fair market value based on posted spot market prices will be sustained as consistent with the regulation in the absence of a showing that this is inconsistent with fair market value.

2. Administrative Procedure: Rulemaking—Federal Oil and Gas Royalty Management Act of 1982: Royalties—Oil and Gas Leases: Royalties: Natural Gas Liquid Products—Outer Continental Shelf Lands Act: Oil and Gas Leases

   A policy guideline interpreting the royalty valuation regulation as it applies to natural gas liquid products is properly distinguished from a regulation having the force and effect of law promulgated in accordance with the rulemaking requirements of the Administrative Procedure Act. Although such a policy guideline is not binding on the Board and will not be followed where it is inconsistent with the relevant regulation, it will be upheld by the Board on appeal where it provides a reasonable basis for a decision applying the royalty valuation regulation and is consistent therewith.

3. Federal Oil and Gas Royalty Management Act of 1982: Royalties—Oil and Gas Leases: Royalties: Generally—Outer Continental Shelf Lands Act: Oil and Gas Leases

   In the absence of acceptance of the lessee's royalty valuation as conclusive by an official

authorized to bind the Department on this matter, the Department is not barred from rejecting the valuation, valuing production by another acceptable method, and demanding payment of royalty based on this method.

4. Federal Oil and Gas Royalty Management Act of 1982: Royalties—Oil and Gas Leases: Royalties: Natural Gas Liquid Products—Outer Continental Shelf Lands Act: Oil and Gas Leases

   Where the low posted spot market price for the month for natural gas liquid products is found by MMS to establish the fair market value floor for royalty valuation, a decision assessing additional royalty charges based on the difference between lessee's reported valuation and the average spot market price will be set aside and remanded.

APPEARANCES: R. Carol Harvey, Esq., Houston, Texas, for Conoco Inc.; Gary H. Hoff, Esq., Dallas, Texas, for ARCO Oil and Gas Company; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

## OPINION BY ADMINISTRATIVE JUDGE GRANT

Conoco Inc. (Conoco) and ARCO Oil and Gas Company (ARCO) appeal from a July 7, 1987, decision of the Director, Minerals Management Service (MMS), affirming orders of the Regional Manager, Tulsa Regional Compliance Office, Royalty Manage-

ment Program (RMP), MMS, dated March 31, 1986, requiring payment of additional royalties for natural gas liquid products (NGLP) produced from certain offshore oil and gas leases. The orders required Conoco to pay $46,491.94 in additional royalties for NGLP produced from January 1980 through April 1983, and assessed ARCO additional royalties in the amount of $16,082.46 for iso-butane and butane produced in the same time period. The NGLP at issue were all separated at the Grand Chenier Gas Processing Plant from gas produced from various Outer Continental Shelf oil and gas leases and were used by appellants rather than marketed. Conoco and ARCO also appeal from the August 28, 1987, decision of the Acting Director, MMS, affirming the Tulsa Regional Manager's June 3, 1986, orders assessing $35,708.57 in late payment charges against Conoco and $15,592.26 in late payment charges against ARCO.

An understanding of the issues raised by these royalty valuation appeals is facilitated by some background in the royalty history of these leases. In 1981, the Office of the Inspector General (OIG), U.S. Department of the Interior, conducted a general audit of Conoco's Federal oil and gas leases for the years 1978 through 1980. The purpose of the audit was to determine if Conoco's settlement procedures adequately provided for the proper computation and payment of royalties for the gas removed from its Federal leases. The OIG concluded that, with certain exceptions, Conoco's settlement system for the payment of royalties did not contain any material weaknesses and adequately provided for the reasonable payment of royalties. The OIG also noted that Conoco used actual net-back values as the basis for its determination

of the value of NGLP produced from the leases. Although the OIG found certain problems with the calculation of royalties on NGLP, these problems did not directly relate to the net-back method of valuing NGLP. The OIG recommended that the Geological Survey (GS), the predecessor of MMS, direct Conoco to pay additional royalties based on the audit. As a result of this audit, Conoco has indicated that it paid $572,498 in additional royalties for the years 1978 through 1980.

Subsequently, the OIG conducted a specific audit of the royalties paid on NGLP removed from Federal leases and processed by the Grand Chenier Gas Processing Plant for the years 1977 through 1982. Both Conoco and ARCO are among the owners of the plant, and were subject to this audit to determine if their accounting systems adequately provided for the proper computation and payment of royalties on NGLP extracted at Grand Chenier. The OIG found that ARCO sold some of its NGLP to outside parties, but used its share of butane and iso-butane internally, and that ARCO took physical possession of the NGLP at Mont Belvieu, Texas, through an exchange with another company for ARCO's share of the Grand Chenier NGLP. Further, the OIG reported that Conoco used its share of the NGLP internally. With respect to internally used NGLP, the OIG compared the prices reported to MMS with the lowest Mont Belvieu spot market price during the production month to evaluate the accuracy of appellants' royalty valuation of NGLP.

After review of the OIG audit report and appellants' comments on that report, the Tulsa Regional Manager, MMS, informed Conoco and ARCO of his preliminary royalty underpayment determinations by

letters dated August 20, 1985. The letters provided ARCO and Conoco an opportunity to comment or provide any additional documentation to refute the preliminary findings. Both appellants responded to the preliminary determinations of royalty underpayments.

In a decision letter dated March 31, 1986, addressing only the valuation of NGLP for purposes of royalty computation for certain offshore leases,[1] the Regional Manager, MMS, found that Conoco underpaid royalties for internally used NGLP produced from January 1980 through April 1983 in the amount of $46,491.94. The decision letter explained that:

> During the period January 1980 through April 1983, Conoco used its share of NGLP's internally and valued them at average monthly Mont Belvieu spot prices as determined by its marketing department. Instances in which the value of NGLP's used by Conoco was less than the lowest Mont Belvieu spot price for the production month resulted in additional royalties of $46,491.94.

(Decision letter at 2). A similar letter was issued to Conoco, as paying agent for ARCO, with respect to additional royalties in the amount of $16,082.46 due on valuation of butanes and iso-butanes used internally. Conoco and ARCO appealed these decisions to the Director, MMS.

The decisions of the Regional Manager were based in substantial part on the royalty valuation methodology set forth in the "Procedure Paper on Natural

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[1] The decision expressly noted that "lease production volumes, manufacturing allowances, and natural gas values reported are subject to further review."

Gas Liquid Products Valuation" (Procedure Paper) issued by the Royalty Valuation and Standards Division of the Royalty Compliance Division of MMS on December 14, 1984, and revised on February 25, 1985. The Procedure Paper was developed in response to the problems encountered by MMS in establishing an appropriate method of valuing NGLP extracted from gas produced from Federal leases, especially where the NGLP had been used internally. Because the regulations require MMS to establish a basis for royalty using a reasonable unit value which should never be less than the fair market value, *see* 30 CFR 206.150 (1987), the Procedure Paper's stated purpose was to develop a "yardstick" valuation technique for determining the reasonableness of a lessee's NGLP prices (Procedure Paper at 3). In applying this yardstick, MMS distinguished between sales situations in which an arm's-length contract existed and those with non-arm's-length contracts or no contract.

In determining the appropriate yardstick, MMS considered several factors, including NGLP sales contracts, the prices received by lessees, regulated prices, and commercially available NGLP bulletins. Based on an evaluation of these sources, MMS concluded that commercial price bulletins represented the best available price source, and in most instances were indicative of NGLP fair market value (Procedure Paper at 5). The Procedure Paper explained the royalty valuation methodology set forth therein as follows:

> To establish a yardstick to compare to the lessee's reported prices, MMS will take the highest and lowest published prices for the month

> from the appropriate bulletin. If the reported price falls within this range, the value will normally be accepted by MMS for royalty determination purposes.
>
> * * * * *
>
> If the prices used to calculate royalties fall below this range, a minimum value that is acceptable to MMS can be determined by developing an average value from the lowest and highest prices in the range.

*Id.* at 6-7.[2] The Procedure Paper also listed suggested spot price locations for various producing areas and the appropriate bulletins to be used as price sources. For the NGLP at issue in this case, Mont Belvieu, Texas, was the suggested market.

By decision dated July 7, 1987, the Director, MMS, affirmed the assessment of additional royalties based on the methodology set forth in the Procedure Paper. The decision noted that the assessment was based on production used internally by appellants which had been valued for royalty purposes "at less than the lowest Mont Belvieu spot price." The Director found

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[2] The Procedure Paper also discusses NGLP prices in the context of arm's-length sales contracts. For royalty computation purposes, if an arm's-length contract establishes an NGLP price, MMS will normally accept the greater of that contract price or gross proceeds; if lessees have have a non-arm's-length contract and they can establish that the contract has characteristics similar to arm's-length contracts which represent fair market value, MMS will accept the non-arm's-length contract price for royalty valuation purposes. However, under other situations, including where no contract exists, MMS will use the yardstick value as the fair market value. *Id.* at 8-9.

that appellants' calculation of net back for royalty computation purposes includes costs incidental to marketing which are not allowable deductions. Further, the decision held that MMS did allow a fractionation allowance, in addition to a gas plant processing allowance, but that the amount of these allowances was beyond the scope of the present appeal, having been set by prior unappealed decisions. Because RMP had no record of a request for a transportation allowance by either appellant, the Director determined that a deduction for transportation costs was properly disallowed.

The Director further found that the spot prices protested by appellants are a better indicator of value than posted prices which are of long duration involving substantial volumes. The decision concluded that royalty value determinations need not incorporate all of the factors identified in the regulation and that the weight to be afforded each factor is within the discretion of MMS. Further, the Director found that the Procedure Paper is an interpretation of the regulatory requirement to which the notice and rulemaking provisions of the Administrative Procedure Act (APA), 5 U.S.C. § 553 (1982), do not apply. Additionally, the Director ruled that appellants made no overpayments subject to offset during the audit period when they paid on a valuation in excess of the minimum Mont Belvieu spot market price as different values may be considered reasonable as long as they do not fall below the minimum value set. Finally, the Director found that the OIG audit for 1977-1980 did not constitute a ruling on NGLP valuation which would preclude MMS from assessing liability for additional royalty on this basis for 1980. Furthermore, he stated that MMS was required to

audit and reconcile all current and past lease accounts by section 101(c) of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1711 (1982), and to take appropriate action to make additional collections and refunds as warranted.

By orders dated June 3, 1986, the Regional Manager assessed Conoco $35,708.57 and ARCO $15,529.26 in late payment charges for the underpaid royalties. Conoco and ARCO appealed these orders to the Director, MMS, who affirmed the imposition of the late payment assessments by decision dated August 28, 1987.

Conoco and ARCO have each filed a substantial statement of reasons (SOR) for appeal from the Director's royalty valuation decision. Conoco's brief raises four basic issues: the validity of the royalty valuation methodolgy developed in the Procedure Paper; the legality of utilizing this method without formal APA rulemaking; the propriety of applying a procedure developed in 1985 to royalty valuation for an earlier period; and the propriety of reauditing Conoco's Federal offshore leases for a period covered in a previous audit. Conoco first describes the royalty valuation procedure it used for the relevant period, noting that it attempts to accurately represent the actual net-back values for each product at the respective plant. If no specific transaction is made in a particular month,

> then the lease settlement valuation is based on Conoco's assessment of the representative market value for each product at each plant location. To test the validity of this assessment, comparisons are made to public pricing information available

> in various publications such as *Platts Oilgram, Oil Buyers Guide, BP News*, etc., as an external test. At the end of the month, Conoco's prices, based on an assessment of the NGLs market, are used for calculating netbacks to the production point. This calculation recognizes any exchange differentials, physical transportation, storage, fractionation, etc., between the using facilities and the production source, if applicable. Neither exchange differentials nor storage costs are incurred at Grand Chenier so such charges are NOT deducted from royalties.

(Conoco's SOR at 9-10).

Conoco argues that the spot market prices used by MMS are not consistently reflective of fair market value and that they ignore the effect of the location of the gas plant and transportation costs to market. Conoco further contends that MMS' method is arbitrary in establishing a floor for NGLP "based on a spot price methodology for a set market, *e.g.*, Mt. Belvieu spot price for the *entire* Gulf of Mexico, absent another determination by MMS and in unduly *penalizing* lessees whose prices fall below the floor" by requiring a valuation equal to the average of the highest and lowest prices, not the floor of the lowest price (Conoco's SOR at 17; emphasis in original).

Conoco further argues that the Procedure Paper represents a new and different standard for valuing NGLP that creates a substantial change in pre-existing law. Conoco alleges that the procedure is a mandatory directive, prescribing conduct and accounting standards, and not merely a clarification or explanation of existing law or regulations. Therefore, Conoco contends that the Procedure Paper should have

been issued only after compliance with the notice and comment requirements of the APA, and not without any public explanation or input.

Further, Conoco contends that MMS should be estopped from applying the Procedure Paper retroactively. Conoco asserts that the OIG approved its use of actual net-back values as the basis for its royalty valuation in 1981, and that it was without knowledge of the Procedure Paper methodology during the 1980-1983 audit period. Conoco argues that the application of estoppel in this case would not thwart the purpose of the relevant statute because MMS could still value NGLP under the regulations. Conoco further contends that estoppel is necessary to prevent an injustice because Conoco will be damaged by the retroactive valuation procedure. Conoco argues that MMS has not demonstrated that past administrative practices allowing the net-back valuation were improper or that values computed by this method were erroneous.

Finally, Conoco argues that the earlier audit conducted by the OIG in 1981 for the years 1977 through 1980 fully determined its royalty obligations for that period, and that MMS is precluded from assessing any additional royalties for 1980. Conoco states that it relied on the prior audit as conclusive of its obligation to pay additional royalties for that period, and that it paid the deficiencies which surfaced as a result of the audit. Conoco contends that the 1981 audit contained no disclaimers or limitations upon which MMS may rely to reopen that audit. Furthermore, Conoco contends that the OIG tested Conoco's settlement procedures in that audit and found that they provided for the adequate payment of royalties. Under these circumstances, Conoco argues that MMS

is precluded from seeking additional royalties for 1980.

Conoco further argues that consideration by MMS of underpayments on the subject leases requires consideration of any overpayments during the audit period. Appellant reasons that this requires reexamination of the 12.4 percent fractionation fee allowed by MMS—in view of Conoco's actual expense of 13.1 percent for fractionation. The same argument is made with respect to transportation costs of $.48 per gallon for propane.

ARCO contends in its brief on appeal that the Procedure Paper is inconsistent with the requirements of the regulation at 30 CFR 206.150 which mandates consideration of several relevant factors in determining "reasonable unit value" for royalty purposes. ARCO argues that the spot market at a central storage and distribution point relied upon by MMS is arbitrary in that it does not relate to either the location of manufacture or the royalty settlement point. Further, ARCO asserts that the net-back values it used for valuation of NGLP do not reflect marketing costs of any kind (as the MMS decision asserts), but rather reflects valuation on the basis of significant purchases from third parties at the consuming location less transportation costs between Grand Chenier and the consuming location. Further, ARCO contends it is entitled to a transportation allowance to the Mont Belvieu spot market if the latter price is to be dispositive of royalty valuation ARCO asserts the lack of a prior transportation allowance request is not relevant in this context.

In answer to the briefs filed by appellants herein, MMS points out that spot market prices are a type of posted price which is recognized by regulation as

a factor in valuation of oil and gas for royalty purposes. MMS asserts that it properly determined that spot prices are a reasonable indicator of market value for the NGLP at issue here. Further, MMS contends that appellants failed to meet the burden of establishing error in the valuation of the NGLP.

In answer to appellants' assertion of violation of APA rulemaking requirements, MMS argues that it has not retroactively applied a new regulatory requirement for valuation of NGLP. Rather, it is asserted that the Procedure Paper merely provided guidance in applying the existing regulation. It is strongly contended that MMS has the authority to examine royalty payments for prior periods to determine whether royalties were properly paid and require payment of additional royalties due. MMS points out that FOGRMA provides comprehensive authority to audit royalty payments and that the provisions of 30 U.S.C. § 1711 (1982) direct the Secretary to audit and reconcile all current and past lease accounts and to take any appropriate action to collect additional royalties or make refunds as warranted.

MMS further contends that valuing production at the average spot market price is reasonable where lessee's royalty valuation falls outside the range of fair market value. Further, it is contended that MMS cannot be estopped to apply this method of royalty valuation which is consistent with the requirements of the regulations.

With respect to the fractionation allowance on Conoco's ethane of 12.4 percent, MMS asserts this was set by letter of November 7, 1984, which was not appealed and, hence, must be considered final. Further, MMS contends that transportation costs were

properly disallowed because no application for approval of such costs was filed.

Finally, MMS contends that the previous OIG audit of Conoco leases through 1980 does not constitute a bar to further audit of royalty payments for NGLP produced from the leases including the year 1980 in the absence of a final administrative determination of royalties due which did not occur here.

[1] The provisions of the Outer Continental Shelf Lands Act (OCSLA), *as amended*, 43 U.S.C. §§ 1331-1353 (1982), and appellants' leases issued pursuant thereto, require the payment of a royalty on production of oil and gas based on a specified percentage of the amount or value of the oil and gas produced. In passing this Act, Congress committed the Government to the goal of obtaining fair market value for offshore oil and gas resources. *Watt* v. *Energy Action Educational Foundation*, 454 U.S. 151, 162 (1981); *Sun Exploration and Production Co.*, 104 IBLA 178, 184 (1988); *Amoco Production Co.*, 78 IBLA 93 (1983), *aff'd*, *Amoco Production Co.* v. *Hodel*, 627 F. Supp. 1375 (W.D. La. 1986), *vacated and remanded*, 815 F.2d 352 (5th Cir. 1987), *cert. denied*, 56 U.S.L.W. 3891 (U.S. June 28, 1986) (No. 87-372).[3]

The Secretary possesses considerable discretion in determining the value of production for royalty purposes. *Marathon Oil Co.* v. *United States*, 604 F. Supp. 1375, 1382 (D. Alaska 1985), *aff'd*, 807 F.2d 759 (9th Cir. 1986), *cert. denied*, 107 S. Ct. 1593 (1987); *Texaco, Inc.*, 104 IBLA 304, 308 (1988); *Amoco Production Co.*, *supra* at 96. That discretion

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[3] The decision of the district court was vacated for lack of jurisdiction and the case was remanded for transfer to the Claims Court. 815 F.2d at 368.

is tempered by the standard of reasonableness. *Texaco Inc., supra* at 310.

The Secretary's exercise of this discretion during the relevant time period was governed by the provisions of the royalty valuation regulation at 30 CFR 206.150 (1987), formerly 30 CFR 250.64 (1979).[4] That regulation provides:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or a majority of like-quality products produced in the area or field; (b) the price

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[4] Effective Mar. 1, 1988, the Department completely revised the regulations in 30 CFR relating to gas valuation for royalty purposes. 53 FR 1230 (Jan. 15, 1988). The new regulation for processed gas, 30 CFR 206.153, provides that valuation for royalty purposes is to be determined based upon the combined value of the residue gas and all gas plant products, less certain allowances. When the residue gas or any gas plant product is not sold pursuant to an arm's-length contract, the regulation provides that value will be determined in accordance with the first applicable benchmark method listed. These methods include: (1) the gross proceeds accruing from a sale pursuant to a non-arm's-length contract which is comparable to an arm's-length contract; (2) values determined by consideration of other information relevant in valuing like-quality gas or products including proceeds from arm's-length contracts, posted prices, spot prices, and other reliable public sources of price or market information, and other information particular to the individual lease; and (3) a net-back method or any other reasonable method to determine value. 30 CFR 206.153(c), 53 FR at 1276. References in this decision are to gas regulations in effect during the relevant periods in dispute unless otherwise noted.

> received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

30 CFR 206.150 (1987).[5]

The regulation defines several factors which may be properly used in the valuation of NGLP. One of the relevant factors is "posted prices." 30 CFR 206.150 (1987). The Mont Belvieu spot market price for NGLP as published during the production month clearly qualifies as a posted price. Thus, the issue is whether the other factors relevant to NGLP valuation render the use of the posted spot market price arbitrary and capricious as a measure of fair market value. Examining the relevant factors enumerated by the regulation, we note there is no showing by appel-

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[5] Valuation for royalty purposes of natural gas from which NGLP are produced was further guided by the regulation at 30 CFR 206.152 (1987), formerly 30 CFR 250.67 (1979), which provides, in relevant part:

"(a) When gas is processed for the recovery of constituent products, a royalty established by the terms of the lease will accrue on the value or amount of:

"(1) All residue gas remaining after processing, and

"(2) All natural gasoline, butane, propane, or other substances extracted from the gas. * * *

"(b) Under no circumstances shall the amount of royalty on the residue gas and extracted substances be less than the amount which the Director determines would be payable if the gas had been sold without processing."

lants that the posted price is inconsistent with the highest price paid for a part or a majority of like-quality products produced in the area or field. Further, the price received by the lessee, normally a significant factor in royalty valuation, is by definition not applicable in the case of NGLP which are used internally and not marketed. The factor of regulated prices is not relevant here as it appears from the record that the prices of the NGLP involved was deregulated during the timeframe at issue.

The royalty valuation regulation provides a further check on the value obtained by application of the above-referenced factors by requiring that: "Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances * * *." 30 CFR 206.150 (1987). This provision of the regulation has led the Department to value production for royalty purposes on the basis of net-back value to the lessee after subtracting the costs of transportation and processing from the sale price of the production to establish the value at the wellhead on occasion where neither the posted price nor the highest price paid for like-quality products produced in the field is reflective of the proceeds realized by the lessee on sale of the production. *Marathon Oil Co.* v. *United States*, 604 F. Supp. at 1385. In the context of the present case we find nothing in the regulation which would require use of the net-back method of royalty valuation in lieu of reference to such regulatory factors as posted prices.[6]

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[6] We note that the newly amended regulations rank the use of spot prices ahead of the net-back method in their valuation benchmark hierarchy. 30 CFR 206.153(c), 53 FR 1276 (Jan. 15, 1988).

With respect to the question of an allowance for transportation costs, we must recognize that one of the "relevant matters" taken into consideration in applying the royalty valuation regulation for offshore production is the cost of transportation to an onshore market where there is no market at the offshore point of production. In the absence of a market at the wellhead where production would ordinarily be sold and valued, the deduction of a transportation allowance from the market value of the production at the nearest open market has been upheld. *United States* v. *General Petroleum Corp.*, 73 F. Supp. 225, 263 (S.D. Cal.), *aff'd*, *Continental Oil Co.* v. *United States*, 184 F.2d 802 (9th Cir. 1950); *Shell Oil Co.*, 52 IBLA 15, 88 I.D. 1 (1981); *C & K Petroleum, Inc.*, 27 IBLA 15 (1976); *Kerr-McGee Corp.*, 22 IBLA 124 (1975); *The Superior Oil Co.*, 12 IBLA 212 (1973). This transportation allowance has been found applicable to gas from which NGLP is extracted. *Phillips Petroleum Co.*, 109 IBLA 4 (1989). On the other hand, transportation costs have been disallowed where the costs claimed were for transportation beyond the point of the nearest potential market. *See The Superior Oil Co.*, *supra*. Applying these principles to the case at hand, we find no basis has been shown for considering transportation costs from the processing plant at Grand Chenier to Mont Belvieu as ARCO requests (SOR at 6). Similarly, contrary to the contention of ARCO (SOR at 5), transportation costs between Grand Chenier and the "consuming location" would not be allowable. Accordingly, we must conclude that appellants have failed to sustain the burden of showing error in basing royalty valuation on posted Mont Belvieu spot

market prices as opposed to use of a net-back method of valuation.

[2] With regard to the challenge to the Procedure Paper based on the rulemaking provisions of the APA, we find that the Procedure Paper was not a substantive rule subject to the notice and comment provisions of the APA. Substantive rules have the force of law while interpretative rules or general statements of policy are merely clarifications or explanations of existing statutes or rules. *See Guardian Federal Savings & Loan Association* v. *Federal Savings and Loan Insurance Corp.*, 589 F.2d 658, 664 (D.C. Cir. 1978). Substantive rules have the force of law where they constitute a substantive modification of an existing regulation, adoption of a new regulation, or a change in policy. *W.C.* v. *Bowen*, 807 F.2d 1502, 1504 (9th Cir. 1987); *Venlease I*, 99 IBLA 387, 389; *Cambridge Mining Co.*, 74 IBLA 26, 28 (1983). The Procedure Paper merely clarified the existing regulations by setting forth a yardstick by which MMS would measure the reasonableness of royalty values reported by lessees. It did not require lessees to value their production by any specific method, nor did it modify any existing regulation. Rather, it found that, after consideration of the factors listed in the regulations, the best measurement of the reasonable value of NGLP in situations where no arm's-length contract existed was the commercially available spot price bulletins. We find the Procedure Paper to be essentially a policy guideline adopted by MMS to assist in valuing NGLP production for royalty purposes under the provisions of the relevant regulation. As such, it does not have the force and effect of law as a duly promulgated regulation does, and the Board will decline to follow it where it is in-

consistent with the terms of the relevant regulations. *See Black Butte Coal Co.*, 109 IBLA 254, 260 (1989) (declining to apply published guidelines for processing logical mining unit applications which were inconsistent with regulations); *Charles J. Rydzewski*, 55 IBLA 373, 88 I.D. 625 (1981) (declining to apply instruction memorandum which was inconsistent with the relevant regulation).

[3] A further issue has been raised with respect to whether MMS is bound to accept the royalty valuation reached under the net-back method for calendar year 1980 as a consequence of the earlier OIG audit of all of Conoco's Federal oil and gas leases for the years 1978-1980. As a threshold matter, it must be recognized that the authority for valuation of production for royalty purposes within the Department was vested at the time of the audit in the Director, GS, and those officials under his supervision. 30 CFR 250.10(a) and 250.64 (1980).[7] Thus, the fact that the earlier OIG audit did not find fault with the use of the net-back method of valuing NGLP did not constitute approval by the official with delegated authority to approve valuation of production. In the absence of an acceptance of the lessee's royalty valuation as conclusive by an official authorized to bind the Department on this matter, the Department is not barred from rejecting the valuation, valuing production by another acceptable method, and demanding payment of royalty based on this method. *Supron Energy Corp.*, 46 IBLA 181, 189 (1980), *appeal*

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[7] Pursuant to Secretarial Order No. 3071, dated Jan. 19, 1982, the functions of GS relating to oil and gas lease royalty management were subsequently transferred to MMS. 47 FR 4751 (Feb. 2, 1982).

*pending sub nom. Conoco* v. *Andrus*, Civ. No. 80-0261-M (D. N.M. filed Apr. 17, 1980); *Big Piney Oil & Gas Co.*, A-29895 (July 27, 1964). Appellants have not presented the Board with any documentation regarding the additional royalty paid as a consequence of the earlier OIG nationwide audit from which it can be concluded that acceptance of the payment constituted a ruling on the issue of valuation of NGLP processed at Grand Chenier in 1980. Indeed, the fact that a subsequent audit was conducted covering royalties paid on NGLP produced from Federal leases and processed at Grand Chenier for the years 1977 through 1982 would indicate this issue had not been settled. Accordingly, we find the Department was not barred from reviewing the valuation of the NGLP for 1980. Similarly, with respect to the question of estoppel, appellants have shown no basis for estopping MMS from reviewing the valuation of NGLP by appellants for royalty purposes to ascertain whether it represents fair market value as required by statute and regulation and requiring appellants to pay royalty accordingly. *Supron Energy Corp.*, *supra* at 189.

[4] A distinct issue is presented by the manner in which the spot market price is used to value NGLP. The Procedure Paper provides that if the lessee's reported price falls within the range of the high and low spot market prices for the month, the value will normally be accepted for royalty determination purposes. Thus, in effect, the lowest posted spot market price of the month establishes a floor for royalty valuation. This Board has previously upheld the reasonableness of gas royalty valuations consisting of the higher of either a floor value determination predicated on the market for gas from the leases or the gross proceeds realized by the lessee upon sale of the

production. *Supron Energy Corp., supra.* However, we find the present case to be distinguishable. As appellants point out, in the present case a price falling below the floor value is raised not to the floor value, but to a price computed by averaging the floor value with the high spot market price, in effect making the average the floor value. We find that the acceptance of any settlement price within the range of the low to the high spot market price as constituting fair market value is inconsistent with requiring payment of the average spot market price where lessee's settlement price is less than the floor value. While the obligation of MMS to value production at no less than the gross proceeds realized by the lessee may lead to a valuation in excess of the fair market value/floor value where this is reflective of proceeds received by the lessee, the fair market value is the standard at issue in this case where the NGLP were used internally and not marketed. If the average spot market price rather than the floor price constituted fair market value, then MMS would be without authority under the statute and regulation to accept royalty settlement prices as low as the floor price as the Procedure Paper indicates MMS has done. Accordingly, we are unable to affirm the application of the Procedure Paper to the extent it is used to value NGLP production at a price in excess of the fair market value floor price and, hence, must remand this case for recomputation of any additional royalty due and any applicable late payment charges.

To the extent appellants have raised arguments which we have not specifically addressed herein, they have been considered and rejected.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the

Interior, 43 CFR 4.1, the decisions appealed are set aside and remanded to MMS for further action consistent herewith.

/s/ C. Randall Grant, Jr.
C. RANDALL GRANT, JR.
Administrative Judge

I concur:

/s/ Franklin D. Arness
FRANKLIN D. ARNESS
Administrative Judge

**APPENDIX G**

[Filed Nov. 1, 1994]

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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93-1377

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PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT

*versus*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL.,
DEFENDANTS-APPELLEES

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ATLANTIC RICHFIELD COMPANY,
PLAINTIFF-APPELLANT

*versus*

BRUCE BABBITT, Secretary of Department of Interior,
ET AL., DEFENDANTS-APPELLEES

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PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT

*versus*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL.,
DEFENDANTS-APPELLEES

---

PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT

*versus*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL.,
DEFENDANTS-APPELLEES

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Appeals from the United States District Court
for the Northern District of Texas

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ON PETITION FOR REHEARING AND
SUGGESTION FOR REHEARING EN BANC
(November 1, 1994)

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Before SMITH and BARKSDALE, Circuit Judges and WALTER, District Judge *.

PER CURIAM:

(✓) The Petition for Rehearing is DENIED and no member of this panel nor Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc, (FRAP and Local Rule 35) the Suggestion for Rehearing En Banc is also DENIED.

ENTERED FOR THE COURT:

/s/ [Illegible]
United States Circuit Judge

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* District Judge of the Western District of Louisiana, sitting by designation.

Judge Duhé did not participate in the consideration of the suggestion for rehearing en banc.

**APPENDIX H**

[Filed Sept. 7, 1994]

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

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No. 93-1377

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PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT

*versus*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL.,
DEFENDANTS-APPELLEES

---

ATLANTIC RICHFIELD COMPANY,
PLAINTIFF-APPELLANT

*versus*

BRUCE BABBITT, Secretary of Department of Interior,
ET AL., DEFENDANTS-APPELLEES

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PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT

*versus*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL.,
DEFENDANTS-APPELLEES

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PHILLIPS PETROLEUM COMPANY,
PLAINTIFF-APPELLANT

*versus*

GARY JOHNSON, Area Manager, Dallas Area Compliance Office, Minerals Management Service, ET AL.,
DEFENDANTS-APPELLEES

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Appeals from the United States District Court
for the Northern District of Texas

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(CA:89-1707-H c/w 3:89-2393-H;
3:89-2727-H & 3:89-2751-H)

ON PETITION FOR REHEARING AND
SUGGESTION FOR REHEARING EN BANC

Before SMITH and BARKSDALE, Circuit Judges, and WALTER,* District Judge.

JERRY E. SMITH, Circuit Judge: **

No member of this panel nor Judge in regular active service on the court having requested that the court be polled on rehearing en banc, the suggestion for rehearing en banc is DENIED. The petition for rehearing is GRANTED so that we may address an

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* District Judge of the Western District of Louisiana, sitting by designation.

** Local Rule 47.5.1 provides: "The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that rule, the court has determined that this opinion should not be published.

issue that we inadvertently omitted from our previous opinion in this case. This supplemental opinion modifies our opinion issued on June 10, 1994, 22 F.3d 616 (5th Cir. 1994).

We previously reversed the district court's grant of summary judgment to defendants because we concluded that the MMS Procedure Paper was a substantive rule promulgated without notice and comment. Two of the four consolidated cases did not, however, involve the Procedure Paper. Concluding that the statute of limitations does not bar the agency's action, we affirm the district court's grant of summary judgment to defendants in those cases.

## I.

Phillips contends that the MMS orders are invalid, as they cover royalties due from a period outside the six-year limitation period imposed by 28 U.S.C. § 2415(a), which bars "every action for money damages" brought by the United States unless the "complaint is filed within six years." Phillips and ARCO contend that (1) MMS orders are "actions," and (2) royalty demands are actions "for money damages."

The term "action for money damages" refers to a suit in court seeking compensatory damages. The plain meaning of the statute bars "every action for money damages" unless "*the complaint* is filed" within six years." [*sic*] (Emphasis added.) Thus, actions for money damages are commenced by filing a complaint. Actions that do not involve the filing of a complaint are not "action[s] for money damages." Since the government has filed no complaint,[1] the agency action

[1] This suit is for declaratory judgment brought by Phillips and ARCO; moreover, the agency order cannot be construed as a complaint.

is not a "action for money damages." Thus, § 2415 is no bar.

In addition, the meaning of the phrase "money damages" is narrowly construed. *See Bowen v. Massachusetts*, 487 U.S. 879, 893 (1988) ("The fact that a judicial remedy may require one party to pay money to another is not sufficient reason to characterize the relief as 'money damages.' "). "Money damages" normally refers to a sum of money used as compensatory relief. *Id.* at 897.

By contrast, orders issued by MMS seek monies due under a contract with the government. Such contractual obligations cannot be considered compensatory. Agency orders are therefore not barred by the limitations period of § 2415. Consequently, we affirm the district court's grant of summary judgment to defendants on those causes not affected by the Procedure Paper. In all other respects, our prior opinion is unmodified. The judgment is AFFIRMED IN PART and REVERSED IN PART.

**APPENDIX I**

December 14, 1984
(with February 25, 1985 revisions)

*Minerals Management Service*
*Royalty Valuation and Standards Division*
*Royalty Compliance Division*
*Procedure Paper*

*on*

*Natural Gas Liquid Products Valuation*

I. *Introduction*

A. Statement of Problem

B. Time Periods Involved

1. Control Period
2. Decontrol Period

C. Sales Situations Involved

1. Arm's-length Contract
2. Non-arm's-length Contract/No Contract

II. *Valuation Policy*

A. Development of Yardstick Values

B. Application of Yardstick Values

1. Effect of DOE Regulations on the Valuation Policy
2. Valuation of NGLP's
   (a) Arm's-length Contracts
      (i) Decontrol Period
      (ii) Control Period
   (b) Non-arm's-length Contracts/No Contract
      (i) Decontrol Period
      (ii) Control Period

C. Other Issues

1. Transportation Adjustments
2. Processing Allowance

Attachments

1. Table of Price Sources
2. Overview of Applicable DOE Regulations

## I. *Introduction*

### A. Statement of Problem

Recent reviews of gas plants by the Royalty Compliance Division and the Office of Inspector General have raised questions regarding the appropriate method of valuing natural gas liquid products (NGLP's) extracted from gas produced on Federal and/or Indian lands. This valuation problem is particularly prevalent in cases where NGLP's have been transferred internally between affiliated entities.

MMS regulations require the Secretary to establish a basis for computing royalties using a reasonable unit value. This value should never be less than the fair market value as determined by guidelines established by the Secretary. At a minimum, royalties must be paid on the gross proceeds accruing to the lessee.[1]

The purpose of this paper is to develop a "yardstick" valuation technique for determining the reasonableness of a lessee's NGLP prices. This task is complicated by the fact that from 1973 until January 1980 (February 1981 for propane), NGLP's, except ethane, were regulated under Department of Energy (DOE) regulations 10 CFR 212 "Mandatory Petroleum Price Regulations". Since the Department of the Interior's position is that DOE regulations are applicable in

[1] For the purposes of this paper, the term "lessee" was used for simplicity. "Payor may be interchangeable with "lessee" in cases where the reporting entity is not the lessee but has asumed the lessee's responsibilities.

the valuation of minerals, the regulations' impact on NGLP valuation must also be addressed.

B. Time Periods Involved

The NGLP yardstick to be developed must span two distinct time periods:

1. 1973 to January 1980 (February 1981 for propane) or the *"Control Period"*

   - This is the period when the DOE regulations, 10 CFR 212 "Mandatory Petroleum Price Regulations" were in effect. Because of the six-year statute of limitations, the MMS is generally concerned only with January 1978 forward. DOE regulations never controlled ethane.

2. January 1980 (February 1981 for propane) to the present, and prospectively, or the *"Decontrol Period"*

   - This period is marked by the end of controlled NGLP prices.

C. Sales Situations Involved

In the review of a lessee's method of valuing NGLP's, MMS must consider the type of sales situation that occurred and the criteria used to establish a royalty value. Values must also be reviewed for DOE pricing restraints during the control period.

The following is a discussion of the types of sales situations that MMS normally recognizes:

1. *Arm's-length Contracts*

   - "Arm's-length contract" is a contract or agreement that was freely arrived at in the

open market place between independent, non-affiliated parties of adverse economic interests. The contract did not involve any considerations other than the sale of NGLP's and was prudently negotiated under the facts and circumstances existing at the time.

2. *Non-arm's-length Contracts/No Contract*

- "Non-arm's-length contract" is any contract that cannot meet the arm's-length negotiation criteria. Internal transfers and interaffiliate sales including written agreements between affiliated entities, are considered non-arm's-length contracts.
- "No contract" occurs when no written agreement exists for the sale of NGLP's.

## II. *Valuation Policy*

A. Development of yardstick values

- In an effort to develop a yardstick for determining the reasonableness of a lessee's NGLP prices, the following sources were considered:
  - NGLP sales contracts
  - Prices received by lessees
  - Table 7 (DOE) prices
  - Commercially Available NGLP Bulletins
- A study of these sources concluded that commercial price bulletins represent the best available price source and in most instances are indicative of NGLP fair market value.

- The following three bulletins are recommended: Platt's Oilgram Price Report, Oil Buyers' Guide, and Weekly BPN Propane Newsletter. However, none of these bulletins published NGLP prices prior to 1980, only Oil Buyers' Guide published prices before 1983, and Platt's is not available prior to July 1983. Therefore, the best available sources for NGLP market prices are: 1) DOE Table 7 prices prior to January 1980; 2) Oil Buyers' Guide for January 1980 to December 1982; 3) Oil Buyers' Guide or BPN Newsletter for January to July 1983; and 4) Platt's Oilgram for July 1983 forward.

- Platt's Oilgram will be the preferred price source; Oil Buyers' Guide and Weekly BPN Newsletter should be used as backup when Platt's fails to publishd prices or does not cover a particular area. For instance, establishing yardstick prices for California production would dictate using BPN Newsletter since it is the only bulletin that quotes LA Basin Prices. Attachment 1 outlines producing areas, suggested location and pricing sources to be used during the various time periods.

- To establish a yardstick to compare to the lessee's reported prices, MMS will take the highest and lowest published prices for the month from the appropriate bulletin. If the reported price falls within this range, the value will normally be accepted by MMS for royalty determination purposes. The following table provides an example of this procedure:

NGLP Prices for Month of July 1983
at Mt. Belvieu (Texas, Gulf Coast)

| PRODUCT | Week of: 7-6-83 | Week of: 7-13-83 | Week of: 7-21-83 | Week of: 7-27-83 |
|---|---|---|---|---|
| ETHANE | 31.50 | 31.50 | 31.50 | 32.00-32.25 |
| PROPANE | 49.25-49.50 | 49.25-49.50 | 49.00 | 47.75-48.00 |
| ISO-BUTANE | 71.00 | 70.00-70.50 | 70.00 | 70.00 |
| N-BUTANE | 66.75 | 67.00-67.75 | 67.00 | 67.25-67.50 |
| NATURAL GASOLINE | 75.00 | 74.00-74.25 | 74.25 | 74.25 |

All prices in cents per gallon (¢/gal)

Using the July 1983 figures from the sample, the yardstick price ranges are:

| | Monthly Low | | Monthly High |
|---|---|---|---|
| Ethane | 31.50 | — | 32.25 |
| Propane | 47.75 | — | 49.50 |
| Iso-Butane | 70.00 | — | 71.00 |
| N-Butane | 66.75 | — | 67.75 |
| Natural Gasoline | 74.00 | — | 75.00 |

Any lessee reporting royalties on Gulf of Mexico production using prices that fall within these ranges will normallly meet MMS criteria for royalty determination purposes.

- If the prices used to calculate royalties fall below this range, a minimum value that is acceptable to MMS can be determined by developing an average value from the lowest and highest prices in the range. An example of this procedure follows:

Month of July 1983
Mt. Belvieu

| PRODUCT | LOWEST PRICE | HIGHEST PRICE | AVERAGE MONTHLY PRICE |
|---|---|---|---|
| ETHANE | 31.50 | 32.25 | 31.875 |
| PROPANE | 47.75 | 49.50 | 48.625 |
| ISO-BUTANE | 70.00 | 71.00 | 70.50 |
| N-BUTANE | 66.75 | 67.75 | 67.25 |
| NATURAL GASOLINE | 74.00 | 75.00 | 74.50 |

B. Application of the yardstick value.

1. Effect of DOE Regulations on the Valuation Policy

MMS regulations require royalties to be calculated using a fair market value for NGLP's. A lessee may be using a maximum permissible price that is less than the fair market yardstick value estabished by MMS. Since the maximum permissible price was the highest price a lessee could have received under the DOE regulations, MMS will consider this price to be the fair market value for royalty purposes. The maximum permissible price is the price computed using all available costs that could be allocated to an individual product. Attachment 2 provides an overview of the DOE regulations.

2. Valuation of NGLP's

(a) Arm's-length contracts

(i) Decontrol Period

If lessees have a true arm's-length contract which establishes an NGLP price, MMS will normally accept the

arm's-length contract price for royalty purposes unless the gross proceeds received were higher than the contract price. For royalty computation purposes, MMS will accept the greater of the arm's-length contract price or gross proceeds.

(ii) Control Period

If the lessee received a maximum permissible price under the DOE regulations which was less than the contract price, the maximum permissible price becomes the fair market value to use for royalty computation purposes. Otherwise, contract prices or gross proceeds are considered fair market value.

(b) Non-arm's-length contracts/No contract

(i) Decontrol Period

If lessees have a non-arm's-length contract which establishes an NGLP price *and* the lessee can demonstrate that the contract has characteristics similar to arm's-length contracts which represent fair market value, MMS will accept the non-arm's-length contract price for royalty computation purposes. If there are no arm's-length contracts for the same field or area, or the non-arm's-length contract does not represent fair market value, the yardstick value is considered fair market value.

(ii) Control Period

If the lessee received a maximum permisible price under the DOE regulations which was less than the yardstick price, the maximum permissible price becomes the fair market value to use for royalty computation purposes. Otherwise, yardstick prices or gross proceeds are considered fair market value.

C. Other Issues

1. Transportation Adjustments

- NGLP's are an integral part of the wet gas stream and become separate, distinct products at the tailgate of the processing plant. At this point they become useable or saleable products.
- MMS has determined that commercial bulletin yardstick prices represent fair market value for usable NGLP's. MMS will use these prices as the base value for royalty purposes. However, MMS recognizes that these prices represent a broad, market area value and the lessee sometimes must incur transportation costs to move NGLP's from the processing or fractionation plant to the market area sales point. MMS will allow adjustments made to the market area price for transportation costs incurred, provided the lessee can submit documentation in support of such adjustments.

2. Processing Allowance

- Processing allowances are an MMS approved deduction from NGLP values when royalties are paid on the residue gas and NGLP's remaining after processing. These allowances are based on actual processing costs incurred by the lessee. If approved, a lessee can be allowed a processing allowance up to 2/3 of the value of NGLP's.
- Generally speaking the formula used for computing a processing allowance is:

$$\text{Percent Allowance} = \frac{\text{Operating Cost}}{\text{NGLP Value}}$$

Since the NGLP value is the fraction's denominator, the processing allowance percentage becomes smaller as the NGLP value increases. The ultimate impact of any NGLP value increase is a reduction in the processing allowance.

- If MMS determines that a company has improperly valued NGLP's and establishes a market value using this procedure, the processing allowance will require recalculation.

*ATTACHMENT 1*—Table of Price Sources

| Producing Area | Suggested * Location | 1977, 1978, 197 |
|---|---|---|
| Gulf of Mexico, Texas, Louisiana | Mt. Belvieu, TX | Table 7 (DOE (National Pric |
| West Coast | LA Basin | Table 7 (DOE |
| Oklahoma, Kansas, Nebraska | Conway,@ KS | Table 7 (DOE |
| Alabama, Mississippi | Conway,@ KS | Table 7 (DOE |
| Rocky Mtn. Region | Conway,@ KS | Table 7 (DOE |
| New Mexico | Mt. Belview [*sic*], TX | Table 7 (DOE |
| Alaska, Eastern U.S. | As yet undetermined, consult | |

* *Suggested* location to be used, each valua
nate location would be more pertinent than

+ Only one bulletin should be used, Platt's
of the other bulletins will be used.

• BPN is the only bulletin that publishes W
as backup when BPN is incomplete.

@ "Conway, KS" and "Group 140" are syn
KS.

| | Years | | |
|---|---|---|---|
| | 1980, 1981, 1982 | Jan. to May 1983 | July 1983 Forward + |
| ) | Oil Buyers' Guide | Oil Buyers' Guide<br>BPN Newsletter | Platt's Oilgram<br>Oil Buyers' Guide<br>BPN Newsletter |
| | Oil Buyers' Guide | BPN Newsletter • | BPN Newsletter • |
| | Oil Buyers' Guide | Oil Buyers' Guide<br>BPN Newsletter | Platt's Oilgram<br>Oil Buyers' Guide<br>BPN Newsletter |
| | Oil Buyers' Guide | Oil Buyers' Guide<br>BPN Newsletter | Platt's Oilgram<br>Oil Buyers' Guide<br>BPN Newsletter |
| | Oil Buyers' Guide | Oil Buyers' Guide<br>BPN Newsletter | Platt's Oilgram<br>Oil Buyers' Guide<br>BPN Newsletter |
| | Oil Buyers' Guide | Oil Buyers' Guide<br>BPN Newsletter | Platt's Oilgram<br>Oil Buyers' Guide<br>BPN Newsletter |

with RVSD when necessary

on case should be separately evaluated to determine if an alter-
the suggested location.

Oilgram is the suggested first choice. If Platt's is incomplete, one

st coast prices. BPN is the suggested source with Platt's Oilgram

nymous, BPN uses Group 140 and Oil Buyers' Guide uses Conway,

*ATTACHMENT 2*—Overview of Applicable DOE Regulations

- The price of covered NGLP was controlled by DOE (formerly Federal Energy Administration, Federal Energy Office and Cost of Living Counsel) regulations issued August 17, 1973. The pricing of NGLP was subject to Subpart E, Refiners, of the DOE regulations until December 20, 1974, when DOE issued a new Subpart K, Natural Gas Liquids. Subpart K was adopted to provide a set of price rules tailored to the purpose of regulating the prices charged for NGLP's. The changes in the regulations effected by Subpart K were effective from January 1, 1975, forward.
- A Delaware Federal District Court decision, which was affirmed by the Temporary Emergency Court of Appeal (TECA), held that the DOE regulations authorized first sale treatment for interaffiliate NGLP transfers. Therefore, interaffiliate NGLP transfer prices would be treated the same as any other NGLP prices under DOE regulations.

1. Impact of applicable regulations

(a) *Independent Gas Plant Operators*

- Gas plant operators that only refine liquid hydrocarbons (independents) determined their maximum legal selling prices (MLSP) pursuant to Subpart K based upon May 15, 1973, selling prices plus increased costs calculated under Subpart K. The independ-

ent gas plant operator had the option of determining MLSP on a plant-by-plant or firm-wide basis. However, once this election was made, it had to be consistently applied. The independent gas plant operator's NGLP prices might be different for each of his plants based upon his election and at times the MLSP for a particular plant might be lower than other sellers in the same area.

- *DOE Regulations Pertinent to Independents*

Subpart K

10 CFR 212.161(b) Relationship to other subparts

"(1) Gas plant operators. Refiners that only refine liquid hydrocarbons from oil and gas field gases and do not refine crude oil shall determine their maximum lawful prices pursuant to this Subpart K and are not also subject to Subpart E."

10 CFR 212.164 Adjusted May 15, 1973, first sale price.

"(a) Natural gas liquid products. For purposes of determining lawful prices of natural gas liquid products in a first sale pursuant to this subpart, a firm may use, in lieu of the weighted average price at which natural gas

liquids products were lawfully priced in first sales transaction with a class of purchaser on May 15, 1973, prices of not more than $.085 per gallon for propane, not more than $.09 per gallon for butane and not more than $.10 per gallon for natural gasoline."

10 CFR 212.168(b) Aggregation of increased product cost.

"Where increased product costs measured with respect to particular volumes of natural gas or natural gas liquids processed in one or more gas plants in a month are different, (1) the increased product costs measured with respect to a particular volume of natural gas may be allocated to the particular sales volumes of natural gas liquid products produced therefrom; or in the alternative, (2) the total amount of increased product costs measured with respect to the total amount of natural gas and natural gas liquids processed in one or more gas plants under common ownership in a month may be allocated to the total sales volume of natural gas liquid products produced therefrom, provided that once an election in accordance with this paragraph has been made, the elected method of allocating product costs shall continue to be used in the months subsequent to the election."

(b) *Integrated Refiners*

- Generally speaking, an integrated refiner could have supported actual selling prices or intercompany transfer prices at a fair market value under the DOE regulations. If companies can demonstrate that the maximum permissible price under DOE regulations is less than fair market price, then the maximum permissible price becomes the fair market value to be used for MMS royalty purposes.
- Integrated refiners determined their adjusted May 15, 1973, selling prices and increased costs for NGLP's under Subpart K. The increased costs calculated under subpart K were then transferred to the cost allocation formula under Subpart E, Refiners. Refiners then determined DOE theoretical MLSP for all products on a firm-wide basis under Subpart E using the cost pool generated by increased cost calculated under both Subpart K and E. The DOE regulations did not require MLSP for NGLP's to be based upon only increased costs calculated under Subpart K for an integrated refiner.
- *DOE Regulations Pertinent to Integrated Refiners*

Subpart K

10 CFR 212.161(b)(2) provides that integrated refiners could use the adjusted May 15, 1973, first sales price:

"Refiners that refine liquid hydrocarbons from oil and gas field gases, and also refine crude oil, shall determine their May 15, 1973, selling prices and increased product and processing costs for natural gas liquids and natural gas liquid products produced in gas plants pursuant to this Subpart K, but shall determine their maximum lawful selling prices pursuant to Subpart E."

10 CFR 121.161(b)(2)(ii) and (iii) further provides that integrated refiners shall add the amount of increased costs determined under Subpart K to the amount of increased costs incurred in each month of measurement and determined to be allocable to the appropriate product category under the refiner's cost allocaton formulae of 212.83(c).

Subpart E

10 CFR 212.83 generally provides that refiners determine DOE maximum legal selling prices for NGLP's and refined products under Subpart E using an increased cost pool generated from increased costs calculated under both Subpart K and E.

(c) *General DOE Regulations*

10 CFR 212.161 Definitions.

"First sale" means, with respect to NGL's/NGLP's, the first transfer for value to a class of purchaser for which a fixed price per unit of volume is determined.

"Net-back sale" means with respect to NGL's, any transfer for value to a class of purchaser for which a percentage of the revenue from the first sale of NGL's/NGLP's is received.

10 CFR 212.163 General price rule.

(b) "Net-back sale. A royalty owner, producer, gas plant owner, gas plant operator, or other entity that transferred NGL's/NGLP's to any class of purchaser on May 15, 1973, in a net-back sale shall not charge (or receive) per gallon revenues for such NGL's/NGLP's in excess of the per gallon revenues received in such net-back sales on May 15, 1973, except to the extent that the first sale price upon which the net-back amount is determined is permitted to increase above its May 15, 1973, level pursuant to this subpart, and except to the extent that the method for determining the amount of the net-back is changed, provided however, that any change in the method of determining the amount of any net-back shall not constitute an increased product cost or an increased non-product cost."

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NO. 94-1292

Supreme Court, U.S.
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In the
Supreme Court of the United States

OCTOBER TERM, 1994

BRUCE BABBITT,
SECRETARY OF THE INTERIOR, ET AL.,
PETITIONERS

v.

PHILLIPS PETROLEUM COMPANY AND
ATLANTIC RICHFIELD COMPANY,
RESPONDENTS

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

# BRIEF OF ATLANTIC RICHFIELD COMPANY IN OPPOSITION

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## QUESTION PRESENTED

Whether the Interior Department may retroactively change a regulation establishing criteria for determining the royalty value of natural gas liquids produced under federal mineral leases without first complying with the notice-and-comment requirements of the Administrative Procedure Act.

## RULE 29.1 STATEMENT

Atlantic Richfield Company has no parent company, and it has only the following non-wholly owned subsidiaries:

85819 Canada Limited
AAPSS93, Inc.
AAPSS94, Inc.
Agro Internacional, S. de R. L. de C.V.
Alyeska Pipeline Service Company
AM/PM Japan Co. Ltd.
Arco Chemical Company
ARCO Solar Nigeria Ltd.
Badger Pipeline Company
Black Lake Pipe Line Company
Blair Athol Coal Pty., Limited
Colonial Pipeline Company
Compania de Petroleo Ganso Azul, Ltda.
Cook Inlet Pipe Line Company
Dalrymple Bay Coal Terminal Pty., Ltd.
Dixie Pipeline Company
East Heidelberg Salt Water Disposal Co.
East Texas Salt Water Disposal Co.
Iricon Agency Ltd.
Kenai Pipe Line Company
Kuparuk Transportation Capital Corp.
Kuparuk Transportation Company
Logan Aluminum Inc.
Lyondell Petrochemical Company
Olympic Pipe Line Company
Platts Pipe Line Company
Prince William Sound Oil Spill Response Corporation
Tecumseh Pipe Line Company
Texas-New Mexico Pipe Line Company
Vastar Resources, Inc.

## TABLE OF CONTENTS

QUESTION PRESENTED ..... i

RULE 29.1 STATEMENT ..... ii

TABLE OF CONTENTS ..... iii

TABLE OF AUTHORITIES ..... iv-vii

STATEMENT ..... 1

ARGUMENT ..... 9

I. The Court Should Not Consider Interior's New Argument That The Procedure Paper Is Not A Rule ..... 11

II. Interior's Concern That Undue Burdens Are Being Placed On The Administrative Process Is Unfounded ..... 12

III. Given The Fifth Circuit's Factual Findings, The Court's Decision Is Not Dependent On The "Substantial Impact" Test Of *Brown Express* ..... 18

CONCLUSION ..... 24

## TABLE OF AUTHORITIES

**CASES:** **PAGE**

*American Mining Congress v. MSHA*, 995 F.2d 1106 (D.C. Cir. 1993) . . . . . 20

*Amoco Production Co. v. Lujan*, 877 F.2d 1243 (5th Cir.), *cert. denied*, 493 U.S. 1002 (1989) . . . . . 17

*Bendix Autolite Corp. v. Midwesco Enterprises, Inc.*, 486 U.S. 888, 108 S. Ct. 2218, 100 L. Ed. 2d 896 (1988) . . . . . 11

*Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 109 S. Ct. 468, 102 L. Ed. 2d 493 (1988) . . . . . 14

*Brown Express, Inc. v. United States*, 607 F.2d 695 (5th Cir. 1979) . . . . . 9,10,18,19,21

*First Bancorporation v. Bd. of Governors*, 728 F.2d 434 (10th Cir. 1984) . . . . . 16

*Guernsey Memorial Hosp. v. Secretary of HHS*, 996 F.2d 830 (6th Cir. 1993), *cert. granted*, 114 S. Ct. 1395 (1994) (argued Oct. 31, 1994) . . . . . 11,19

*Industrial Safety Equip. Ass'n, Inc. v. EPA*, 837 F.2d 1115 (D.C. Cir. 1988) . . . . . 20

*JEM Broadcasting Co., Inc. v. FCC*, 22 F.3d 320 (D.C. Cir. 1994) . . . . . 22

## TABLE OF AUTHORITIES (continued)

**CASES:** **PAGE**

*Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33 (D.C. Cir. 1974) ..... 21

*Phillips Petroleum Co. v. Lujan*, 963 F.2d 1380 (10th Cir. 1992) ..... 17

*Rivera v. Becerra*, 714 F.2d 887 (9th Cir. 1983), *cert. denied*, 465 U.S. 1099 (1984) ..... 21

*Southern California Edison Co. v. FERC*, 770 F.2d 779 (9th Cir. 1985) ..... 22

*Taylor v. Freeland & Kronz*, 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed. 2d 280 (1992) ..... 11

**ADMINISTRATIVE DECISIONS:**

*Amoco Production Co.*, 112 IBLA 77 (1989) ..... 16

*Cities Serv. Oil & Gas Corp.*, 112 IBLA 89 (1989) ..... 16

*Cities Serv. Oil & Gas Corp.*, 113 IBLA 255 (1990) ..... 16

*Mobil Oil Corp.*, 112 IBLA 56 (1989) ..... 16

*Phillips Petroleum Co.*, 117 IBLA 255 (1991) ..... 16

*Shell Offshore Inc.*, 116 IBLA 246 (1990) ..... 15

## TABLE OF AUTHORITIES (continued)

PAGE

**ADMINISTRATIVE DECISIONS:**

*Texaco Inc.*, GS 119 O&G (Jan. 15, 1979) . . . . . 12,13

*Union Oil Co. and Union Exploration Partners, Ltd.*, 111 IBLA 369 (1989) . . . . . 16

*Union Oil Co. of Cal. and Union Exploration Partners, Ltd.*, 116 IBLA 8 (1990) . . . . . 16

**STATUTES:**

5 U.S.C. § 553(b)(3)(A) . . . . . 2

5 U.S.C. § 553(c) . . . . . 1

5 U.S.C. § 553(d) . . . . . 1

30 U.S.C. § 1711(c) . . . . . 13

43 U.S.C. § 1337(a)(1)(B) . . . . . 2

Notice to Lessees No. 5 Gas Royalty Act of 1987, Public Law 100-234, enacted Jan. 6, 1988 . . . . . 13

**REGULATIONS:**

30 C.F.R. § 206.150 (1987) . . . . . 3,12

42 Fed. Reg. 22,610 (May 4, 1977) . . . . . 13

## TABLE OF AUTHORITIES (continued)

PAGE

**REGULATIONS:**

47 Fed. Reg. 16,423 (Apr. 16, 1982) ..... 13

53 Fed. Reg. 1184 (Jan. 15, 1988) ..... 13

53 Fed. Reg. 1230 (Jan. 15, 1988) ..... 13

**OTHER AUTHORITIES:**

Memorandum of the Acting Director, MMS, dated June 29, 1983 ..... 14

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**BRIEF OF ATLANTIC RICHFIELD COMPANY IN OPPOSITION**

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## STATEMENT

The Administrative Procedure Act ("APA") requires that agency rules be published in the Federal Register at least 30 days before they become effective. 5 U.S.C. § 553(d). Affected parties must be given prior notice of and an opportunity to comment on the proposed rules. 5 U.S.C. § 553(c). Only "interpretative rules, general statements of

policy, [and] rules of agency organization, procedure, or practice . . ." are exempt. 5 U.S.C. § 553(b)(3)(A).

The Fifth Circuit held that new criteria adopted by the Interior Department for establishing the royalty value of natural gas liquids produced under federal mineral leases did not fall within any of the APA's enumerated exceptions. Accordingly, since Interior had not promulgated the rules in accordance with the APA's notice-and-comment requirements, the Fifth Circuit held that they could not be enforced retroactively against Atlantic Richfield Company.

Atlantic Richfield Company, through its unincorporated division ARCO Oil & Gas Company ("ARCO"), leases federal lands for oil and gas exploration, development, and production.[1] As lessee, ARCO pays royalties to the government based on the value of the production saved, removed, or sold from the leased premises. 43 U.S.C. § 1337(a)(1)(B). Interior, through its Minerals Management Service ("MMS"), administers the leases and collects the royalties due thereunder.

When ARCO produces natural gas that contains a high volume of liquefiable hydrocarbons (commonly known as "wet" gas), it sometimes processes the gas to separate the liquids from the dry methane, or "residue" gas. The liquids are then fractionated to separate the various individual products, such as ethane, propane, butane, and

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[1] During the pendency of this litigation, all of the affected leases were assigned by Atlantic Richfield Company to a newly created subsidiary, Vastar Resources, Inc.

natural gasoline (natural gas liquid products or "NGLPs"). This case concerns the valuation, for royalty purposes, of NGLPs that ARCO produced from its federal offshore leases during the period October 1980 through February 1988, and that it used internally in its own manufacturing operations.

During 1980-1988, the period relevant to this case, the governing regulation authorized the MMS Director to establish the royalty value of federal lease production, provided he gave due consideration to several enumerated factors:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

30 C.F.R. § 206.150 (1987).

Believing that it was in compliance with this regulation, ARCO valued its internally used NGLPs for royalty purposes based on third-party transactions in the market place as reported in a variety of publications. That ARCO's valuations were, in fact, in compliance with the gov-

erning MMS regulation was confirmed by a 1984 audit by Interior's Office of Inspector General ("OIG"). The OIG audited ARCO's royalty payments on NGLPs produced at the Grand Chenier processing plant and concluded that ARCO did not owe any additional royalties on its internally used NGLPs. Later that same year, however, Interior developed a new set of rules for valuing NGLPs. These new rules were set forth in an unpublished agency paper referred to as the "Procedure Paper."

In place of the range of different types of prices that were required to be considered under the regulation (area, actual, posted, and regulated prices), the Procedure Paper mandated the use of only one type of price — the spot market price. Even more specifically, the Procedure Paper mandated the use of a particular spot market price — the price published in a single designated bulletin. For example, for NGLPs produced from federal leases in the Gulf of Mexico, the Procedure Paper specified the use of the spot market price published for the Mont Belvieu, Texas, trading center by Oil Buyer's Guide for 1980 to 1982 and by Platt's Oilgram for 1983 forward.

Spot market prices are not even mentioned in the regulation. Posted prices are mentioned; however, as was correctly found by the Fifth Circuit, posted prices and spot market prices are not the same. A posted price is a publicly announced price at which a purchaser is willing to buy a certain type and amount of petroleum product. By comparison, spot market prices reflect actual transactions, usually on a short-term or one-time basis. Pet.App. 11a.

ARCO was first advised of the Procedure Paper's ex-

istence in August 1985, almost a year after it was developed. At that time, ARCO was advised that the MMS had *reaudited* the royalties previously audited by the OIG, this time using the 1984 Procedure Paper. ARCO was further advised that, based on the MMS' application of the Procedure Paper, additional royalties were found to be due for the period 1980-1983.

Since the Procedure Paper did not exist at the time these royalties were paid, ARCO had used a different methodology (based on third party transactions reported in a variety of publications — not just the one bulletin later specified by the Procedure Paper) to determine the fair market value of its internally used NGLPs. Notably, there has been no determination by the MMS that ARCO's methodology was unreasonable. Nor has there been a determination that ARCO's methodology resulted in the payment of any less royalties during the audit period than would have been payable using the Procedure Paper's values. Rather, additional royalties were assessed only because ARCO's values *for certain months* were less than the Procedure Paper's values. This distinction is significant, as is illustrated by the following example.

If, during a two-month period in 1980, ARCO's values were 15¢ and 25¢, respectively, and the Oil Buyer's Guide spot market price for the Mont Belvieu, Texas, trading center for the same months was 20¢ for each month, retroactive application of the Procedure Paper would require ARCO to pay additional royalties for the first month based on the Procedure Paper's 20¢ value, but ARCO would not be allowed any credit for the higher 25¢ value that it used in the second month. Under the

Procedure Paper, ARCO would have to pay additional royalties on 5¢ for the first month even though the overall value under its methodology was exactly the same as the value under the Procedure Paper — a total of 40¢ for the two months in question.

As is illustrated by this example, ARCO is not being required to pay additional royalties because its methodology produced a value that was less than fair market value. According to the Procedure Paper, 40¢ — the value ARCO used — was fair market value for the two months in question. Thus, Interior is wrong when it asserts that the issue presented by its Petition is whether Interior should be precluded from enforcing its determination that ARCO failed to pay royalties on fair market value. There has been no determination that ARCO failed to pay royalties on fair market value — only a determination that ARCO's values did not coincide, on a month-by-month basis, with the spot market price published in the particular bulletin specified in the Procedure Paper. This, however, is not surprising since, at the time most of the royalties were paid, the Procedure Paper did not even exist. ARCO therefore had no way of knowing that the bulletin specified in the Procedure Paper should have been used.

There is, of course, no reason why ARCO could not, and would not, have used the bulletin specified in the Procedure Paper if it had known of the Procedure Paper's requirements. This certainly would have been easier than ferreting out actual transactions from various published sources in order to determine the fair market value of its internally used NGLPs. Even more importantly, if ARCO had had timely notice of the Procedure Paper's requirements, it could have avoided taking an unnecessary

risk that its values would not exactly coincide with the Procedure Paper's values on a month-by-month basis, with the attendant risk that additional royalties would be assessed. Indeed, as the above example illustrates, if ARCO had had timely notice of the Procedure Paper's requirements, it could have used the "correct" bulletin, *paid exactly the same amount of royalties,* and not have been subject to an assessment for additional royalties.

Believing that it should have been given advance notice of the Procedure Paper's valuation criteria and an opportunity to comment on those criteria *before* they became effective, ARCO appealed the MMS assessment administratively, first to the MMS Director and then to Interior's adjudicatory tribunal, the Interior Board of Land Appeals ("IBLA"). The IBLA rejected ARCO's APA arguments, stating that the Procedure Paper did not have the force and effect of law and that the IBLA could decline to follow it if the IBLA chose to do so. The IBLA, however, did not choose to decline to follow the Procedure Paper. Rather, with only a slight modification, the MMS' use of the Procedure Paper was affirmed, and ARCO was directed to pay the additional royalties found to be due. Since the IBLA's decision constituted final agency action, ARCO filed suit for judicial review.

Shortly after the IBLA's decision was rendered, three additional MMS orders were issued.[2] These orders require ARCO to recalculate its royalties, using the Procedure Paper as modified by the IBLA, for all internally used NGLPs produced from all of ARCO's federal offshore

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[2] Orders dated September 6, 7 and 29, 1989, Pet.App. 71a, 86a and 91a.

leases, for each and every month during the period October 1980 through February 1988.[3] Because the IBLA already had decided the issue, ARCO filed an immediate suit for judicial review. Notably, Interior agreed in the trial court that it would have been futile for ARCO to exhaust its administrative remedies with respect to these three MMS orders in light of the IBLA's prior decision.[4]

The district court upheld Interior's actions. The Fifth Circuit reversed, holding that the IBLA's decision, as well as the three MMS orders, were invalid. The Fifth Circuit recognized that the notice-and-comment requirements of the APA " 'were designed to assure fairness and mature consideration of rules of general application.' " Pet.App. 9a-10a, *quoting NLRB v. Wyman-Gordon Co.*, 394 U.S. 759, 764, 89 S. Ct. 1426, 1429, 22 L. Ed. 2d 709 (1969). Looking beyond at the label given to the Procedure Paper by the MMS and the IBLA, the Fifth Circuit looked at how the agency in fact had applied the Procedure Paper. Notwithstanding the agency's assertion that the Procedure Paper was merely a clarification of the existing regulation, the Fifth Circuit found that "it effects a change in the method used by MMS in valuing NGLPs." Pet.App. 8a. *See also id.* at 4a (the Procedure Paper established "new criteria" for valuing NGLPs. As such, the Procedure

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[3] The MMS acknowledged in the September 6 order that ARCO's royalties actually were overpaid, not underpaid, for the period reviewed. Despite this fact, ARCO was directed to recalculate its royalties for all other periods because of the so-called "systemic" error identified by the auditors, *i.e.*, ARCO's failure to use the particular price bulletin later specified by the Procedure Paper.

[4] Defendants' Response to Phillips' Motion for Preliminary Hearing, filed in the district court on September 24, 1990, at 6.

Paper changed, rather than simply interpreted, the existing regulation. Citing cases from various jurisdictions, including *Brown Express, Inc. v. United States*, 607 F.2d 695 (5th Cir. 1979), the Fifth Circuit held that the Procedure Paper established substantive rules that could not be applied retroactively because Interior had failed to comply with the notice-and-comment requirements of the APA. Accordingly, the court held that ARCO could not be required to retroactively recalculate and pay additional royalties based on the new valuation criteria set forth in the Procedure Paper.

## ARGUMENT

Interior argues that this Court should grant its Petition for two reasons. First, Interior asserts that the Fifth Circuit's decision has broad and potentially serious implications for the efficient functioning of the administrative process because it precludes an agency's compliance personnel from applying initial compliance policies without having to go through the burdensome notice-and-comment procedures of the APA. Interior also asserts that this case presents an appropriate occasion to settle a recurrent issue of considerable importance under the APA, *i.e.*, the validity of the "substantial impact" test articulated in *Brown Express*. Neither argument has any merit.

The Fifth Circuit's decision in this case does not impose undue burdens on Interior. In the past, Interior has had no difficulty whatsoever complying with the APA when it adopted new criteria for establishing fair market value for royalty purposes. Its auditors also have not previously had any trouble complying with the agency's own requirement that they use the royalty valuation rules

and policy guidance that were in effect during the period covered by the audit — not new criteria developed later.

Interior's more general concern regarding the needs of governmental compliance personnel to make initial enforcement decisions is similarly unfounded — at least under the facts here. This case does not involve the application of an initial compliance policy that will be enforced — and perhaps modified — in subsequent orders and adjudicatory proceedings. Rather, this case involves a final agency requirement that new valuation criteria be applied retroactively — rigidly and without exception — to all internally used NGLPs produced from all of ARCO's federal offshore leases, for each and every month during the period October 1980 through February 1988. Moreover,the result for other lessees has been exactly the same.

Finally, whatever the Court may think of the legal test articulated in *Brown Express,* this is not an appropriate case for reviewing that test. The Fifth Circuit's decision in this case was based on its conclusion that the Procedure Paper established new criteria for valuing NGLPs — criteria that did not merely implement the governing regulation, but that changed the requirements of the regulation. Given these facts, it is abundantly clear that Interior violated the APA under any legal standard that might be applied.

## I. The Court Should Not Consider Interior's New Argument That The Procedure Paper Is Not A Rule.

Interior argues for the first time in its Petition to this Court that "there is a substantial question whether the paper fits the APA's definition of a 'rule' at all." Pet. 15. Interior did not raise or brief this issue in the courts below. Pet.App. 6a (the agency did not argue that its action was not a rulemaking, only that the Procedure Paper was exempt from the APA's notice-and-comment requirements). Absent unusual circumstances (which Interior has not shown to be present here), this Court should not consider a new issue that was not raised below.[5]

In any event, there is no authority (and Interior cites none) for the startling proposition that the Procedure Paper cannot be considered to be an APA "rule" because it "was compiled by subordinate officials." Pet. 15. To the contrary, manuals compiled by lower-echelon agency personnel acting in the course and scope of their duties unquestionably are "rules" within the APA's broad definition.[6]

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[5] *E.g., Taylor v. Freeland & Kronz*, 503 U.S. 638, 112 S. Ct. 1644, 1649, 118 L. Ed. 2d 280 (1992); *Bendix Autolite Corp. v. Midwesco Enterprises, Inc.*, 486 U.S. 888, 895, 108 S. Ct. 2218, 2223, 100 L. Ed. 2d 896 (1988).

[6] *E.g., Guernsey Memorial Hosp. v. Secretary of HHS*, 996 F.2d 830 (6th Cir. 1993), *cert. granted*, 114 S. Ct. 1395 (1994) (argued Oct. 31, 1994) (agency manual on Medicare reimbursement clearly was a rule; the only issue before the Court is whether it was a substantive or interpretative rule).

## II. Interior's Concern That Undue Burdens Are Being Placed On The Administrative Process Is Unfounded.

The United States Department of the Interior has a right that few, if any, private mineral lessors are able to secure from their lessees — the right to determine the value of the minerals produced, which in turn determines the amount of royalties owed. This right, while extensive, is not unlimited.

The regulation in effect during the period relevant to this case *required* the MMS Director, in making value determinations, to give due consideration to a number of specifically enumerated factors, including the price received by the lessee, the price received by others for like-quality production, posted prices, regulated prices, and other relevant matters. 30 C.F.R. § 206.150 (1987).

Lease limitations also exist. Like the regulation, ARCO's leases authorize Interior to establish reasonable minimum values for royalty purposes *only after* due consideration is given to the same factors enumerated in 30 C.F.R. § 206.150 (1987). Many of these leases further provide that "[e]ach such determination shall be made *only after due notice* to the lessee and a reasonable opportunity has been afforded the lessee to be heard." (Emphasis added.)

Interior itself has recognized that the APA imposes a similar limitation. For example, in *Texaco Inc.*, GS 119 O&G (Jan. 15, 1979), the Acting Director of the U. S. Geological Survey (the MMS' predecessor) invalidated two

unpublished notices that established new royalty-valuation criteria similar to those at issue here. The Acting Director correctly concluded that "the Geological Survey has in effect changed the regulations without complying with the requirements of the Administrative Procedure Act" — regulations essentially identical to the regulations in effect during the period at issue here.

Notably, Interior did not argue in *Texaco,* as it does here, that giving lessees notice of new royalty-valuation criteria before they become effective will somehow threaten the orderly conduct of the government's administrative business. Indeed, Interior routinely has followed the APA's notice-and-comment procedures when establishing new criteria for determining fair market value for royalty purposes.[7]

Interior's concern regarding undue burdens being placed on governmental compliance personnel, who must be allowed to make initial enforcement decisions, is likewise unfounded. Notably, the burdens complained of are not simply the result of the Fifth Circuit's decision. Congress, in the Federal Oil and Gas Royalty Management Act ("FOGRMA"), expressly prohibits Interior's auditors from retroactively applying new valuation criteria. 30 U.S.C. § 1711(c) (the agency "shall conduct audits and reconciliations of lease accounts in conformity with the

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[7] *See, e.g.,* 53 Fed. Reg. 1184 (Jan. 15, 1988) (oil product valuation); 53 Fed. Reg. 1230 (Jan. 15, 1988) (valuation of gas and NGLPs); 47 Fed. Reg. 16,423 (Apr. 16, 1982) (notice of hearing on fair market value of offshore gas for royalty purposes); 42 Fed. Reg. 22,610 (May 4, 1977) (rules for determining onshore gas royalty values), subsequently repealed in part by Notice to Lessees No. 5 Gas Royalty Act of 1987, Public Law 100-234, enacted Jan. 6, 1988.

business practices and recordkeeping systems which were required of the lessee by the Secretary for the period covered by the audit").[8]

Interior has not previously complained that this statutory requirement poses a threat to the orderly conduct of the agency's business. To the contrary, Interior itself has acknowledged that its auditors cannot, and should not, apply new valuation criteria retroactively:

> All product value guidance issued to royalty payors which describes methods for calculating fair market value for purposes of royalty calculations shall be prospective in nature. *In auditing past activities of royalty payors,* the Office of the Inspector General and *the MMS will apply the regulations and policy guidance which were in effect at the time that this specific royalty transaction or transactions occurred.*[9]

Interior also is incorrect when it suggests that this case involves only the application of an initial compliance policy that will be enforced — and perhaps modified — in subsequent orders and adjudicatory proceedings. First, In-

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[8] Given the FOGRMA's prohibition against the retroactive application of new valuation criteria, Interior has an additional barrier to overcome in seeking reversal of the judgment in this case. Under this Court's decision in *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 109 S. Ct. 468, 102 L. Ed. 2d 493 (1988), administrative rules cannot be given retroactive effect unless there is an express statutory grant of authority to enact retroactive rules. There is no such express statutory grant here; instead, the applicable statute expressly provides to the contrary.

[9] Memorandum of the Acting Director, MMS, dated June 29, 1983 (emphasis added).

terior's assertions to the contrary notwithstanding, the Procedure Paper does not allow lessees an opportunity to demonstrate fair market value by other methods. The Procedure Paper does allow lessees selling to affiliates under non-arm's-length contracts to show that those contracts have characteristics similar to arm's-length contracts.[10] That, however, is not the case here. ARCO did not sell to an affiliate, it used its liquids internally. In this circumstance, the Procedure Paper does not allow the lessee to demonstrate fair market value by other means. Rather, it mandates the use of its "yardstick" value. Indeed, the Procedure Paper itself expressly proclaims that "the yardstick value *is considered fair market value.*"[11]

Interior's assertion that this case only involves an initial enforcement policy also ignores the fact that ARCO already has appealed to both the MMS Director and the IBLA. With only a slight modification, the MMS' use of

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[10] Pet.App. 136a. Even in this situation, the lessee is merely afforded an opportunity to establish that the terms of its non-arm's-length contract are similar to the terms of other arm's-length contracts; it is not given an opportunity to independently establish that its contract price constituted fair market value. *See, e.g., Shell Offshore Inc.*, 116 IBLA 246, 255 (1990).

[11] Pet.App. 136a (emphasis added). Notably, an earlier draft of the Procedure Paper would have allowed lessees an opportunity to demonstrate fair market value by other means: "Before MMS undertakes any billing, using these prices, companies should be given the opportunity to present other sources they believe to be more valid (should they disagree with the MMS's valuation procedure)." This language was stricken by the Associate Director for Royalty Management, who wrote: "Don't agree! They can appeal but I don't want to negotiate specific valuation determinations with them."

the Procedure Paper was affirmed as final agency action. Moreover, the two administrative decisions cited by Interior for the proposition that an auditor's initial nonbinding application of the Procedure Paper can perhaps be modified as the result of subsequent adjudicatory proceedings both involved non-arm's-length affiliate sales — a different situation than is involved here. As noted above, the Procedure Paper expressly allows lessees with non-arm's-length contracts to show that their contracts are similar to arm's-length contracts; the IBLA merely required Interior to follow that rule.[12] By comparison, in cases similar to this one involving internally used NGLPs, the IBLA has shown no flexibility whatsoever.[13]

Any doubt regarding the final and mandatory nature of the Procedure Paper as an inflexible rule of royalty valuation is laid to rest when one considers the three self-audit orders that also are at issue in this case. These orders direct ARCO to recompute its royalties, using the valuation methodology required by the Procedure Paper as modified by the IBLA in ARCO's prior appeal, for all internally used NGLPs produced from all of ARCO's federal offshore leases, for every month during the period October

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[12] *See Phillips Petroleum Co.*, 117 IBLA 255, 264-65 (1991); *Amoco Production Co.*, 112 IBLA 77, 79 (1989).

[13] *See, e.g., Union Oil Co. and Union Exploration Partners, Ltd.*, 111 IBLA 369 (1989); *Mobil Oil Corp.*, 112 IBLA 56 (1989); *Cities Serv. Oil & Gas Corp.*, 112 IBLA 89 (1989); *Cities Serv. Oil & Gas Corp.*, 113 IBLA 255 (1990); *Union Oil Co. of Cal. and Union Exploration Partners, Ltd.*, 116 IBLA 8 (1990). Indeed, in light of the IBLA's inflexible application of the Procedure Paper, a notice-and-comment rulemaking would have been required even if the Procedure Paper itself never existed. *See e.g., First Bancorporation v. Bd. of Governors*, 728 F.2d 434, 438 (10th Cir. 1984).

1980 through February 1988. ARCO did not appeal the orders administratively. Rather, it filed an immediate suit for judicial review. Nevertheless, Interior conceded in the trial court that requiring ARCO to pursue administrative appeals of the orders would have been futile, since the IBLA already had finally decided the issue.

The agency's far-reaching self-audit orders are sustainable only if the agency has correctly identified an error (here, ARCO's failure to use the Procedure Paper's values for royalty purposes) that is "systemic" in nature, *i.e.*, an error that results from the use of an incorrect royalty formula.[14] Interior's position that the self-audit orders in this case are valid thus concedes that the Procedure Paper is not merely a provisional, non-binding guideline for its own auditors' internal use, but a royalty formula capable of "systemic" application.

Additionally, unless the Procedure Paper is viewed as mandating a particular royalty formula that leaves no room for discretionary determinations to be made in its application, the challenged orders would run afoul of the settled rule that Interior's discretionary authority to value federal lease production for royalty purposes cannot be delegated to Interior's lessees.[15]

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[14] *See, e.g., Phillips Petroleum Co. v. Lujan*, 963 F.2d 1380, 1386 (10th Cir. 1992) (Interior lawfully can require lessees to correct repeated royalty underpayments caused by "systemic deficiencies"); Pet.App. 43a (the district court in this case rejected ARCO's argument that the self-audit requirements of the orders were unlawful because the court found that the orders merely required ARCO "to recalculate royalties based on the correct formula").

[15] *E.g., Amoco Production Co. v. Lujan*, 877 F.2d 1243, 1250 (5th Cir.), *cert. denied*, 493 U.S. 1002 (1989).

If, as Interior now contends, the Procedure Paper provides only a flexible guideline or policy to be applied on a case-by-case basis, the self-audit requirements of the challenged orders cannot be sustained and Interior's discretionary valuation authority has been improperly and unlawfully delegated. On the other hand, if, as the Fifth Circuit held, the Procedure Paper imposes a mandatory, non-discretionary formula for determining value, the APA was violated when Interior failed to comply with the act's notice-and-comment requirements.

Under the facts of this case, Interior's concern regarding the creation of undue administrative burdens is unfounded.

## III. Given The Fifth Circuit's Factual Findings, The Court's Decision Is Not Dependent On The "Substantial Impact" Test Of *Brown Express.*

The factual findings on which the Fifth Circuit's decision was based are succinctly stated in the decision as follows:

> The rule narrowly restricts the discretion of MMS officials in determining the value of NGLP's. It forecloses other valuation methods by prescribing binding valuation criteria. Although the regulation allows the use of *posted* prices in determining the value of NGLP's, the Procedure Paper mandates the use of *spot* prices. Thus, the Procedure Paper does not even comport with the regulation in using posted prices. Moreover, the Procedure Paper eliminates the other four factors in determining the value of the NGLP's.

> This change in valuation technique dramatically affects the royalty values of all oil and gas leases.

Pet.App. 10a-11a. While these facts certainly support the Court's conclusion that the Procedure Paper violated the APA under the "substantial impact" test of *Brown Express*, they also compel the conclusion that the APA was violated under any test that might be applied.

With regard to the question of whether the Procedure Paper falls within the APA's exception for interpretative rules, Interior does not quarrel with the Fifth Circuit's test, which was whether the Procedure Paper merely *interpreted* the then-existing royalty valuation regulation, or whether it effected a *change* in that regulation. Instead, Interior challenges only the Fifth Circuit's finding that, under the facts of this case, a change was effected, *i.e.*, that the royalty-valuation criteria established in the Procedure Paper were new. Pet. 18-19. As noted above, the version of the facts on which Interior relies is demonstrably incorrect. The Procedure Paper does indeed mandate a particular valuation methodology for internally used NGLPs; it does not allow lessees to demonstrate fair market value by other methods.

Noteably, this is not a case where the governing statute or a regulation previously adopted by the agency is silent on the issue addressed. Nor is there any ambiguity in the regulations such that, in determining whether a conflict with later unpublished guidelines exists, the agency's interpretation of its regulations is arguably entitled to deference.[16] Rather, the regulation at issue in this case

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[16] *See, e.g., Guernsey Memorial Hosp. v. Secretary of HHS*, 996 F.2d 830 (6th Cir. 1993), *cert. granted*, 114 S. Ct. 1395 (1994) (argued Oct. 31, 1994).

expressly states that, in determining royalty values, the MMS Director shall consider certain enumerated factors. For the agency to make another, unmentioned factor determinative of value clearly is legislative — not interpretative — under the very cases that Interior cites as having applied the proper legal standard.[17]

Interior's alternative argument that the Procedure Paper is an exempt general statement of policy is similarly based on an argument that the facts were not as the Fifth Circuit found them to be — not an argument that the Fifth Circuit misapplied the law. Pet. 19-21. In particular, Interior contends that the Procedure Paper is exempt as a general policy statement because its ultimate impact "was and remains heavily dependent on subsequent review and application in particular adjudicatory proceedings." *Id.* at 20-21. As discussed above, the Fifth Circuit found otherwise.

Given the Fifth Circuit's factual finding that the Procedure Paper is mandatory and final, not provisional and subject to later modification on appeal in particular adjudicatory proceedings, the Procedure Paper cannot be deemed to be an exempt policy statement, even under the cases cited by Interior. As these authorities make clear, an agency pronouncement is not a general statement of policy

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[17] *See, e.g., American Mining Congress v. MSHA*, 995 F.2d 1106 (D.C. Cir. 1993) (a rule that effectively amends a prior legislative rule is legislative; not interpretative); *Industrial Safety Equip. Ass'n, Inc. v. EPA*, 837 F.2d 1115, 1120-21 (D.C. Cir. 1988) (rejecting the "substantial impact" test but still recognizing that the agency's unpublished guide would have violated the APA if it had narrowed or altered the grounds for certifying lawful respirator types, *i.e.*, if it had narrowly limited agency discretion to act).

if the pronouncement is binding and finally determinative of the issues or rights to which it is addressed.[18]

With respect to the question of whether or not the Procedure Paper is exempt from the APA's notice-and-comment requirements because it is a rule of agency organization, procedure, or practice, Interior again relies on its characterization of the Procedure Paper as being only provisional and nonbinding. Pet. 21-22. As previously noted, the IBLA repeatedly has applied the Procedure Paper in a final, unwavering and binding manner — and the MMS has directed ARCO to apply the Procedure Paper in the same way. Moreover, with respect to the three self-audit orders that require ARCO to apply the Procedure Paper to revalue all of the internally used NGLPs produced from all of its federal offshore leases, for all months during the period October 1980 through February 1988, Interior itself recognized that administrative appeals would have been futile, since the IBLA already had decided the issue.

Notably, this is not a case where the Fifth Circuit's application of the "substantial impact" test of *Brown Express* resulted in the APA's notice-and-comment requirements being extended to agency action that is otherwise exempt under the APA.[19] Rather, the question in this case is whether the Procedure Paper falls within one of the statutory exemptions. In particular, the Fifth Circuit applied the "substantial impact" test to determine whether

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[18] *See, e.g., Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33, 38 (D.C. Cir. 1974).

[19] *See, e.g., Rivera v. Becerra*, 714 F.2d 887 (9th Cir. 1983), *cert. denied*, 465 U.S. 1099 (1984).

the Procedure Paper falls within the APA's exemption for rules of agency organization, procedure, or practice.

Interior rejects this test; however, under the cases relied on by Interior as applying the correct test, the result is exactly the same. For example, in *JEM Broadcasting Co., Inc. v. FCC*, 22 F.3d 320, 326-27 (D.C. Cir. 1994), the court held that substantive rules alter the rights or interests of parties, whereas procedural rules do not — that a rule affecting the time for filing an application was procedural, whereas a rule affecting the substantive criteria to be applied to the application would be substantive. Similarly, in *Southern California Edison Co. v. FERC*, 770 F.2d 779, 783 (9th Cir. 1985), the court held that agency rules relating to the procedural aspects of the FERC's approval of rates — interventions, requests for refunds of interim rates and for final confirmation and approval — were exempt, but only because these *procedural* provisions did not affect the *substance* of the rate proceedings.

Under these cases, the Procedure Paper clearly is substantive, not procedural. The Procedure Paper does not regulate the form of the agency's proceedings; rather, it goes to the substance of the rights at issue in the agency's proceedings. This is because it dictates the substantive criteria to be employed in determining value, not merely the procedures to be followed in raising valuation issues within the agency.

In sum, the Procedure Paper meets all recognized criteria for being a substantive rule because it:

- imposes substantive obligations upon lessees;

- is determinative of the valuation issues addressed;

- rewrites the existing regulation by narrowly constricting the discretion of MMS officials in determining the value of NGLPs; and

- forecloses alternative valuation methods, thereby conclusively affecting the rights of federal lessees.

Interior does not suggest that different criteria should be applied. Rather, it argues that, as a factual matter, the Procedure Paper is only a non-binding guideline to be used by Interior's auditors in making initial enforcement decisions. As the Fifth Circuit correctly found, however, the facts are otherwise.

In place of the flexible approach required by the governing regulation, which mandated a case-by-case consideration of multiple factors, the Procedure Paper substituted a single criterion — the published spot market price in a particular bulletin for a particular location — that establishes the value of internally used NGLPs. This type of conclusive determination is the hallmark of a substantive rule. The Fifth Circuit's decision therefore was correct under any test that might be applied.

## CONCLUSION

The Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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No. 94-1292

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MAR 31 1995

# In the Supreme Court of the United States

OCTOBER TERM, 1994

BRUCE BABBITT, SECRETARY OF THE INTERIOR, ET AL., PETITIONERS

*v.*

PHILLIPS PETROLEUM COMPANY AND ATLANTIC RICHFIELD COMPANY, RESPONDENTS

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit**

## BRIEF OF PHILLIPS PETROLEUM COMPANY IN OPPOSITION

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## QUESTION PRESENTED

Whether the Department of the Interior may enforce an unpublished standard that contradicts the published regulation governing the calculation of natural gas royalties — and thus may collect both additional royalties and late payment charges from federal oil and gas lessees that have failed to pay royalties in accordance with the unpublished standard — without first complying with the notice-and-comment provisions of the Administrative Procedure Act, 5 U.S.C. § 553.

## RULE 29.1 STATEMENT

Phillips Petroleum Company has no parent company and has the following non-wholly owned subsidiaries:

Alyeska Pipeline Service Company
Arctic LNG Transportation Company
Bissendorf Biosciences GmbH
Canyon Reef Carriers, Inc.
Chisholm Pipeline Company
Colonial Pipeline Company
Cristal Ltd.
Dixie Pipeline Company
Eagle Sun Company Ltd.
East Texas Salt Water Disposal Company
Explorer Pipeline Company
FLTG Inc.
Heat Transfer Research, Inc.
Kenai LNG Corporation
Multinational Gas and Petrochemical Services Ltd.
Norland GmbH für Grundbesitz und Industrieanlagen
Norpipe A.S.
Norpipe Petroleum UK Ltd.
Norsea Gas A/S
Norsea Gas GmbH
Norsea Pipeline Ltd.
Oil Casualty Insurance Ltd.
Oil Insurance Ltd.
Phillips-Imperial Petroleum Ltd.
Phillips Gas Company
Phillips Morrison Resources Ltd.
Phillips P.C. Resources Ltd.
Phillips Petroleum Singapore Chemicals (Private) Ltd.
Phillips Sumika Polypropylene Company (Partnership)
Phillips-San Juan Partners, L.P.
Piro Implementation, Inc.
Polar LNG Shipping Corporation

Prince William Sound Oil Spill Response Corporation
Renolit-Haus AG
Renolit-Haus GmbH
Southern and Phillips Gas Limited
Sweeny Olefins Limited Partnership
Venezoil, C.A.
Western Desert Operating Petroleum Company
(WEPCO)

## TABLE OF CONTENTS


Page

STATEMENT . . . . . 2

ARGUMENT . . . . . 6

A. The Petition Should Be Denied Because the Spot-Price Rule Is Subject to APA Notice-and-Comment Procedures Under Any Reasonable Standard . . . . . 6

1. The Spot-Price Rule Is Not a "Rule[] of Agency * * * Procedure" Because It Regulates the Primary Conduct of Private Parties . . . . . 7

2. The Procedure Paper Did Not Interpret But Rather Contradicted the Governing Published Regulation . . . . . 10

B. The Unusual Context of the Decision Below Limits Its Effect and Makes It a Poor Vehicle for Resolving Questions Under the Administrative Procedure Act . . . . . 12

C. The Government's Petition Confirms the Importance of the Petition in No. 94-1287, Which Should Be Granted Regardless of the Disposition of the Government's Petition . . . . 13

CONCLUSION . . . . . 15

## TABLE OF AUTHORITIES

**Page**

**Cases**

*American Mining Congress* v. *Mine Safety & Health Administration*, 995 F.2d 1106 (D.C. Cir. 1993) . . . . . 11

*Batterton* v. *Marshall*, 648 F.2d 694 (D.C. Cir. 1980) . . . . . 9

*Brown Express, Inc.* v. *United States*, 607 F.2d 695 (5th Cir. 1979) . . . . . 7, 9

*Chrysler Corp.* v. *Brown*, 441 U.S. 281 (1979) . . . 6, 10

*Department of Transportation* v. *Air Transport Ass'n*, 498 U.S. 1023 (1991), vacated and remanded, 498 U.S. 1077, dismissed as moot, 933 F.2d 1043 (D.C. Cir. 1991) . . . . . 8

*Friedrich* v. *Secretary of HHS*, 894 F.2d 829 (6th Cir.), cert. denied, 498 U.S. 817 (1990) . . . . . 9

*General Motors Corp.* v. *Ruckelshaus*, 742 F.2d 1561 (D.C. Cir. 1984), cert. denied, 471 U.S. 1074 (1985) . . . . . 9

*Industrial Safety Equipment Association* v. *EPA*, 837 F.2d 1115 (D.C. Cir. 1988) . . . . . 8

*JEM Broadcasting Co., Inc.* v. *FCC*, 22 F.3d 320 (D.C. Cir. 1994) . . . . . 9

*Metropolitan School District* v. *Davila*, 969 F.2d 485 (7th Cir. 1992) . . . . . 9-11

*Phillips Petroleum Co.* v. *Lujan*, 963 F.2d 1380 (10th Cir. 1992) . . . . . 5

**TABLE OF AUTHORITIES — Continued**

**Pages**

*Reeder* v. *FCC*, 865 F.2d 1298 (D.C. Cir. 1989) . . . . . 9

*Shalala* v. *Guernsey Memorial Hospital*, 115 S. Ct. 1232 (1995) . . . . . 10, 12

*Southern California Edison Co.* v. *FERC*, 770 F.2d 779 (9th Cir. 1985) . . . . . 9

*State of Ohio Department of Human Services* v. *United States Department of HHS*, 862 F.2d 1228 (6th Cir. 1988) . . . . . 10

*Vermont Yankee Nuclear Power Corp.* v. *Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978) . . . . . 8

**Statutes and Regulations**

5 U.S.C. § 553 . . . . . 6, 10, 11

28 U.S.C. § 2415(a) . . . . . 7, 12

43 U.S.C. §§ 1331-1356 . . . . . 2

43 U.S.C. § 1339 . . . . . 7

30 C.F.R. pt. 206 . . . . . 2

30 C.F.R. § 206.150 (1987) . . . . . 3, 4, 11, 12

30 C.F.R. § 206.150-.159 (1994) . . . . . 4, 11, 12

30 C.F.R. § 206.151 . . . . . 4

30 C.F.R. § 206.153(c)(2) (1994) . . . . . 4

30 C.F.R. § 218.150 . . . . . 3

## TABLE OF AUTHORITIES — Continued

Pages

**Miscellaneous**

Oil and Gas and Sulphur Operations in the Outer Continental Shelf, 44 Fed. Reg. 13,527 (1979) . . . . . 11

Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230 (1988) . . . . . 12

# In the Supreme Court of the United States

OCTOBER TERM, 1994

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No. 94-1292

BRUCE BABBITT, SECRETARY OF THE INTERIOR, ET AL., PETITIONERS

*v.*

PHILLIPS PETROLEUM COMPANY AND ATLANTIC RICHFIELD COMPANY, RESPONDENTS

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**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit**

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## BRIEF OF PHILLIPS PETROLEUM COMPANY IN OPPOSITION

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The government's petition seeks review of a different aspect of the same case that is the subject of Phillips' petition, No. 94-1287, which presents the question whether any statute of limitations applies to government claims that an oil, gas, or other mineral lessee has underpaid royalties. While we believe that the question presented in Phillips' petition merits this Court's review, we submit that, for the reasons that follow, the government's petition should be denied.

The government's petition skirts but cannot avoid the compelling fact that counsels against this Court's review: the agency directive invalidated by the court of appeals both dictated the primary conduct of private parties, *i.e.*, federal natural gas lessees, and contradicted the published regulation that properly applied to the calculation of royalties on federal

natural gas leases. Under any reasonable standard, the court of appeals properly held that the directive could not be applied against respondents because the Secretary had failed to comply with the notice-and-comment provisions of the Administrative Procedure Act ("APA"). Any conflict in the approaches of the various courts of appeals regarding the need for notice and comment accordingly would not affect the outcome of this case.

In addition, the mineral leasing context of this case places the government in a position that differs significantly from its typical role in administrative law cases. The government is both regulator and contractual party, and the spot-price rule at issue in this case not only determined the substance of agency decisions but defined the contractual obligations of private parties. These unique complications make this case an unsuitable vehicle for reviewing broader issues under the APA.

Respondent Phillips Petroleum Company adopts and incorporates herein by reference the Statement and Argument set forth in the Brief of Atlantic Richfield Company in Opposition ("Arco Opp."). We add the following comments.

## STATEMENT

1. The holder of a natural gas lease issued under the Outer Continental Shelf Lands Act (43 U.S.C. §§ 1331-1356) must pay royalties on the value of all minerals produced from the lease. The production of some natural gas often results in the production of certain associated hydrocarbons. These "natural gas liquid products," or "NGLPs," include ethane, propane, iso-butane, N-butane, and natural gasoline.

The lessee is responsible for paying all royalties on a monthly basis. The government, however, generally has a contractual right to determine the value of production on which royalties must be paid. The government exercises that

right pursuant to the extensive regulations governing "product valuation." 30 C.F.R. pt. 206.

Because natural gas royalties generally are a percentage of the value of production, the calculation of that value amounts to a calculation of the royalties due. The government makes that determination, if at all, *post hoc* in an audit of past royalty payments. If the government determines that a lessee has undervalued past production and thus has underpaid past royalties, the lessee is liable not only for the past-due royalties but also for late payment charges. See, *e.g.*, Pet. App. 83a; 30 C.F.R. § 218.150.

Lessees accordingly are placed at a significant financial risk of misgauging the government's later assessment of the reasonable value of production from a lease. As a result, it behooves lessees to calculate the value of production using the same method that the Interior Department is likely to use, as reflected in the published regulations governing the calculation of the value of production.

2. During the period relevant to this case, the regulation applicable to NGLPs established two floors for the value of production: (1) "fair market value," and (2) the actual proceeds to the lessee. 30 C.F.R. § 206.150 (1987). The Director of the Minerals Management Service of the Department of the Interior ("MMS") had the duty to compute the value of production for particular units. The regulation set specific guidelines for this determination:

> In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the proceeds accruing to the lessee from the disposition of the produced substances

> or less than the value computed on the reasonable unit value established by the Secretary.

30 C.F.R. § 206.150 (1987) (designated as 30 C.F.R. § 250.643 until August 1983).

The MMS apparently was unsatisfied with the application of the regulation's five-factor test to NGLPs that either were used directly by the lessee or were sold to an affiliate of the lessee. The Interior Department did not modify the regulation in the first instance, however. Instead, in late 1984 and early 1985, the MMS promulgated a "Procedure Paper on Natural Gas Liquid Products Valuation." Pet. App. 128a-145a. The Procedure Paper did not mention Section 206.150. Instead, the Paper stated that in most circumstances, the MMS would establish the reasonable unit value of NGLPs that were not transferred pursuant to arm's-length contracts by looking to a single source: "spot prices," as reported in specific commercial price bulletins for each NGLP, time period, and geographic area. The Procedure Paper was not by its terms limited to prospective application.

Spot prices are not the same as the "posted prices" identified in Section 206.150. See Pet. App. 11a n.4. The differences were made clear in 1988 when the Interior Department finally promulgated new regulations that superseded both Section 206.150 and the Procedure Paper. See 30 C.F.R. § 206.150-.159 (1994). The new regulation specifically permits the use of "prices received in spot sales" in valuing NGLPs, and clearly distinguishes spot prices from "posted prices." *Id.* § 206.153(c)(2); see *id.* § 206.151 (separately defining "posted price" and "spot sales agreement"). The difference is not trivial: posted prices are the prices that buyers routinely offer on a regular and continuing basis, while spot prices result from purchases by those buyers with immediate (and price-enhancing) needs.

3. In an order issued September 27, 1989, the MMS stated that, because Phillips had not used the method set out

in the Procedure Paper, it had undervalued NGLPs that were used internally without being sold. The order required Phillips to recalculate and pay royalties on all of its offshore leases from January 1977 through February 1988. Pet. App. 78a-85a.

The MMS self-audit and payment order issued to Phillips made clear that for all non-arm's-length NGLP transactions, the lowest published spot price was in fact the minimum value permitted. Pet. App. 81a-82a. The order assumes that the value of production for all non-arm's-length contracts will equal or exceed the relevant spot price. Indeed, as the district court later recognized, the MMS in effect required Phillips to use reported spot prices as the "formulas" to compute the proper royalties. Pet. App. 43a. The predictability (and inflexibility) that result from the treatment of spot prices as "royalty calculation formulas" is the entire basis for the finding of "systemic deficiencies" that alone can justify the broad compulsion of a lessee to revisit years of accounts. See Pet. App. 41a-45a; *Phillips Petroleum Co.* v. *Lujan*, 963 F.2d 1380, 1386 (10th Cir. 1992).

Rather than appealing the MMS orders within the Department of the Interior, Phillips filed suit in the United States District Court for the Northern District of Texas in October 1989.[1] Phillips sought a declaratory judgment that the order was invalid and an injunction against its enforcement. The action was consolidated with lawsuits challenging two other royalty payment orders that the MMS had issued to Phillips, and a similar action filed by the Atlantic Richfield Company. Pet. App. 21a-22a. The consolidated action followed the course set out in the Arco Opp.

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[1] The parties agreed that the MMS orders were final for the purpose of judicial review. Pet. App. 22a n.6.

## ARGUMENT

The petition recites and examines the exceptions to the notice-and-comment requirements of the APA in an effort to distract the Court from the fundamental nature of the spot-price rule — and the fundamental soundness of the decision below on the notice-and-comment issue. Thus, the petition simply ignores what it cannot controvert: the controlling characteristic of the spot-price rule is that it compels lessees to pay royalties measured against spot prices, or face substantial late payment charges. Under these circumstances, the Fifth Circuit unquestionably was correct that the MMS could not enforce the spot-price rule without first subjecting it to public notice and the opportunity for comment mandated by the APA. Moreover, because many of the circumstances compelling that conclusion are unique to the mineral leasing context, this case is a poor vehicle for this Court to review the broader APA issues discussed in the petition.

### A. The Petition Should Be Denied Because the Spot-Price Rule Is Subject to APA Notice-and-Comment Procedures Under Any Reasonable Standard

The petition does not advance a standard for distinguishing rules that are subject to the notice-and-comment requirement of the APA from those that are not. The omission is revealing. As this Court has observed, 5 U.S.C. § 553 effectively distinguishes between, on the one hand, substantive rules that are subject to public notice and the opportunity for comment, and on the other hand, agency pronouncements that are restricted to matters of procedure or that simply elaborate upon existing rules without imposing new or different legislative requirements on their own. *Chrysler Corp.* v. *Brown*, 441 U.S. 281, 301-302 (1981). Under any standard, the spot-price rule in the Procedure Paper, as applied and enforced by the MMS, is a substantive rule that may not be promulgated and enforced without notice and comment. That conclusion is compelled by the facts of this

case and does not depend on the application or the contours of the "substantial impact" test advanced in *Brown Express, Inc.* v. *United States*, 607 F.2d 695, 702 (5th Cir. 1979).

### 1. *The Spot-Price Rule Is Not a "Rule[] of Agency * * * Procedure" Because It Regulates the Primary Conduct of Private Parties*

a. This case presents an unusual situation in which agency action affects — indeed, defines — the contractual duties of private parties. The MMS's adoption of a royalty calculation method for its auditors in fact establishes the royalties that lessees are obligated to pay under their leases.

The government admits that, "[a]s a practical matter, * * * lessees track and report their own production, its value, and the royalties due thereon." Pet. 7. The method that the government uses to evaluate the sufficiency of royalty payments thus dictates any rational lessee's calculation of royalties at the time of payment; the price of correcting underpayments, with interest, far exceeds any potential saving. This is especially true because lessees must claim any royalty overpayment within two years, 43 U.S.C. § 1339, while the government has at least six years to collect underpayments, 28 U.S.C. § 2415(a) — if not forever, as the court below held in the ruling that we have challenged in our petition in No. 94-1287. Thus, if the MMS's method of calculation results in a decision that royalties have been underpaid in some months but overpaid in others, the lessee will be liable for all the underpayments but in most circumstances will be time-barred from recovering any overpayments.

The spot-price rule does not merely set forth a procedure to be followed when the MMS audits royalty payments, but dictates the substantive criteria for a decision as to the adequacy of royalties. By substituting a different standard for royalty calculations, the Procedure Paper impermissibly "narrow[s]" and "alter[s]" the substantive "grounds on which the [MMS] will act" in demanding additional royalties

(*Industrial Safety Equipment Association* v. *EPA*, 837 F.2d 1115, 1120 (D.C. Cir. 1988)) — and, therefore, the substantive standards on which an informed lessee will calculate and pay royalties in the first instance. In other words, the spot-price rule must be followed not merely by government auditors, but by all federal natural gas lessees who wish to avoid underpaying royalties and incurring late payment charges. The spot-price rule clearly is a rule that private parties (*i.e.*, lessees) "must obey"; it therefore was subject to the notice-and-comment requirements of the APA. *Id.* at 1121.

Accordingly, the petition cannot succeed in its strained attempt (at 23-24) to draw analogies between this case and both *Vermont Yankee Nuclear Power Corp.* v. *Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978), and *Department of Transportation* v. *Air Transport Ass'n*, 498 U.S. 1023 (granting certiorari to 900 F.2d 369 (D.C. Cir. 1990)), vacated and remanded, 498 U.S. 1077, dismissed as moot, 933 F.2d 1043 (D.C. Cir. 1991). Both *Vermont Yankee* and *DOT* v. *ATA* involved challenges to agency rules that dealt unambiguously with matters of procedure. The question in *Vermont Yankee* was the extent to which courts could force an agency to engage in proceedings that were concededly beyond those required by the APA. In *DOT* v. *ATA*, a court of appeals had required notice-and-comment procedures for an agency's rules governing discovery, settlement, and hearing procedures.

Here, by contrast, it is not a "procedural device[]" (*Vermont Yankee*, 435 U.S. at 546) but a rule of decision that is at issue. The spot-price rule means that, in the vast majority of cases, the agency will order the payment of back royalties and late payment charges by lessees who failed to use that source in computing their royalty obligations. That is a matter not of procedure, but of substance.

b. What dooms the government's position in this case is not the "substantial impact" test, but another, universally accepted proposition from *Brown Express*: "[T]he label that the particular agency puts upon its given exercise of administrative power is not * * * conclusive; rather it is what the agency does in fact." Pet. App. 7a (quoting *Brown Express*, 607 F.2d at 700). The courts cited in the petition (at 24 & n.8) as rejecting or retreating from the "substantial impact" test nonetheless agree that the government cannot secure immunity from APA rulemaking requirements simply by couching substantive standards of private conduct in terms of the agency's review of that conduct. See, *e.g.*, *JEM Broadcasting Co., Inc.* v. *FCC*, 22 F.3d 320, 326-328 (D.C. Cir. 1994); *Metropolitan School District* v. *Davila*, 969 F.2d 485, 489 (7th Cir. 1992); *Friedrich* v. *Secretary of HHS*, 894 F.2d 829, 834-835 (6th Cir.), cert. denied, 498 U.S. 817 (1990); *General Motors Corp.* v. *Ruckelshaus*, 742 F.2d 1561, 1565 (D.C. Cir. 1984) (en banc), cert. denied, 471 U.S. 1074 (1985).

In the D.C. Circuit, the "procedural" label is reserved for those rules that "do not themselves alter the rights or interests of parties," but merely "alter the manner in which the parties present themselves or their viewpoints to the agency." *JEM Broadcasting*, 22 F.3d at 326 (quoting *Batterton* v. *Marshall*, 648 F.2d 694, 707 (D.C. Cir. 1980)). Rules that, like the spot-price rule, "change[] the substantive criteria" that an agency applies are not procedural and are not exempt under Section 553(b). *Reeder* v. *FCC*, 865 F.2d 1298, 1305 (D.C. Cir. 1989).

The Ninth Circuit agrees that the notice-and-comment requirements apply to rules that "implement existing law [by] imposing general, extrastatutory obligations" and thus "affect the substance" of an agency determination. *Southern California Edison Co.* v. *FERC*, 770 F.2d 779, 783 (9th Cir. 1985). The spot-price rule — which creates an obligation to pay royalties based on a value of production that is no less

than the lowest relevant spot price — does not merely "affect" but in fact dictates the substance of an MMS evaluation of a royalty's sufficiency.

Under Seventh Circuit law, the spot-price rule creates "new * * * duties" by requiring lessees to pay royalties based on a single source of spot prices rather than on the broader and more flexible criteria set out in the regulation. *Davila*, 969 F.2d at 490. And, under the Sixth Circuit's standard, the spot-price rule is clearly "mandatory, not advisory." *State of Ohio Department of Human Services* v. *United States Department of HHS*, 862 F.2d 1228, 1234 (6th Cir. 1988). It imposes an effective floor on what may constitute the "value of production" (or its "fair market value") under the regulation. See *ibid.* (notice-and-comment provisions applied to a rule that "imposed a ceiling *ex proprio vigore*" on a benefit, where the published regulation did not include the ceiling).

In sum, under any reasonable analysis, the spot-price rule is a substantive rule subject to the notice-and-comment provisions of Section 553; indeed, that rule is precisely the kind that would most benefit from the "mature consideration of rules of general application" that consultation with affected parties was intended to produce. *Chrysler Corp.*, 441 U.S. at 303. This case is thus an inappropriate vehicle for fine-tuning the analysis of the statutory standard.

### 2. *The Procedure Paper Did Not Interpret But Rather Contradicted the Governing Published Regulation*

There is another reason why the spot-price rule had to be promulgated under the notice-and-comment procedures of the APA. This Court recently held that "APA rulemaking [is] required" when an agency rule "adopt[s] a new position inconsistent with * * * existing regulations." *Shalala* v. *Guernsey Memorial Hospital*, 115 S. Ct. 1232, 1239 (1995). The spot-price rule was inconsistent with and effectively superseded the five-factor test set forth in the governing

regulation, 30 C.F.R. § 206.150. Just as APA rulemaking was required for promulgation of Section 206.150,[2] so was it necessary for its successor.

The spot-price rule is not an interpretative rule. The MMS did not "rel[y] upon the language of the statute and its legislative history," or on the governing regulation, in order to state "what it thinks the [regulation] requires." *Davila*, 969 F.2d at 492. In announcing the spot-price rule, the Procedure Paper did not even acknowledge the existence of Section 206.150, much less purport to interpret the published regulation. And in direct contravention of the express terms of the regulation, the Procedure Paper itself did not take "posted prices" into account at all.

Indeed, the spot-price rule forbids consideration of posted prices or the other factors enumerated in the regulation. Quite clearly a royalty calculation might comply with the published regulation but not with the unpublished spot-price rule. As a result, the spot-price rule "effectively amends a prior legislative rule," and therefore is subject to the notice-and-comment requirements of Section 553. *American Mining Congress* v. *Mine Safety & Health Administration*, 995 F.2d 1106, 1112 (D.C. Cir. 1993).

The Department was free to make the substantive judgment that "spot prices * * * are a better indicator of value than posted prices" (Pet. App. 106a). Because "posted prices" and not "spot prices" were listed among the factors to be considered under Section 206.150, however, this change to exact increased royalties could come only through an amendment of the regulation using the APA procedures that the Department eventually followed, not through per-

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[2] See Oil and Gas and Sulphur Operations in the Outer Continental Shelf, 44 Fed. Reg. 13,527 (1979) (notice of proposed rulemaking for, *inter alia*, 30 C.F.R. § 250.643, later redesignated § 206.150)).

emptory and unilateral action. See *Shalala*, 115 S. Ct. at 1239.

### B. The Unusual Context of the Decision Below Limits Its Effect and Makes It a Poor Vehicle for Resolving Questions Under the Administrative Procedure Act

The effect of the decision below is not so sweeping as the government suggests. Most regulations that nominally pertain to agency procedure do not in fact create substantive rules of decision or dictate the course of action private parties must take independently of their dealings within the agency. The mineral lease royalty setting is highly unusual: agency action determines the extent of a private party's contractual liability to the government. In addition, the MMS has demonstrated that it can easily promulgate notice-and-comment regulations that alert lessees to the precise methods that will be used to calculate the value of production on which royalties must be paid — as it did in the 1988 regulations that superseded both Section 206.150 and the Procedure Paper. See 30 C.F.R. §§ 206.150-.159 (1994).

The mineral leasing context raises unusual issues because of the government's hybrid role as both regulator and contractual party. As a result, this case is peculiarly inappropriate as a vehicle for broadly examining agency rulemaking under the APA.

Moreover, the Secretary's claim (Pet. 26) that the decision below impairs his ability to conduct the mineral royalty management program should be taken with a large grain of salt. First, because the Procedure Paper was superseded in 1988, its validity has no continuing effect on that program. Second, when the Department ultimately decided to comply with the APA when changing its product valuation methods, it found little difficulty in promulgating detailed new regulations. See Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230 (1988) (codified, *inter alia*, at 30 C.F.R. 206.150-.159); *id.* at 1231

(recognizing the need for continuing "timely revisions to regulatory provisions" in order "to alleviate problems"). The Secretary's apocalyptic warnings are unfounded.

### C. The Government's Petition Confirms the Importance Of the Petition in No. 94-1287, Which Should Be Granted Regardless of the Disposition of the Government's Petition

The Fifth Circuit's decision generated another certiorari petition: Phillips' petition in No. 94-1287. In that petition we ask this Court to review the lower court's determination that the general six-year statute of limitations for contract actions brought by the government, 28 U.S.C. § 2415(a), did not apply to MMS royalty collection actions.[3] Our petition demonstrates that, unlike the APA issue, the statute of limitations issue merits review by this Court.

Indeed, the order against Phillips that is the subject of the government's petition illustrates the extremes to which the MMS is willing to push its asserted (and, in the Fifth Circuit, confirmed) ability to seek stale, allegedly underpaid royalties from lessees. Although the Procedure Paper itself acknowledged that the six-year limitation applied (Pet. App. 131a), the 1989 order required Phillips to recalculate and to pay royalties dating back to January 1977—*12¾ years* before the administrative payment order was issued and *15¾ years* before the government asserted a counterclaim in district court to enforce payment of the alleged contractual liability. See No. 94-1287 Pet. 7-8 & Pet. App. 30a-31a. The government's position on the two issues amounts to a claim that it may amend lease royalty regulations without first seeking the views of those affected by its action, and then enforce the terms of the amendment against lessees to collect

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[3] In response to the government's petition, Atlantic Richfield Company filed a cross-petition (No. 94-1479) on the same statute of limitations issue.

additional royalties on production that occurred in the distant past. It would be especially unjust for this Court to deny review of the statute of limitations issue while raising the possibility of validating the Department's enforcement of the spot-price rule.

Moreover, the combination of the two issues in one case presents a valuable opportunity to conserve judicial resources. Both issues involve the government's attempt to abuse the special position of the Interior Department and the MMS in the mineral leasing program in order to subject private parties to substantial and unjust liabilities. The statute of limitations question results from the government's effort to transform the MMS's ability to issue administrative orders in the course of pursuing its contract claims into a device for removing mineral lease contracts from the scope of the general statute of limitations for contract claims brought by the government. The APA question arises from the government's effort to use the fact that a government agency audits royalties as the premise for imposing substantive requirements on royalty payors that are superficially disguised as mere guidelines for the agency's auditors.

Because the Fifth Circuit correctly decided the APA issue in this unique context, it would be inappropriate to grant review of the question presented in the government's petition. A grant of certiorari in response to the government's petition, however, makes a grant of Phillips' petition all the more necessary in order to avoid injustice.

## CONCLUSION

The petition for a writ of certiorari should be denied. If the petition nevertheless is granted, the petition in No. 94-1287 should be granted and heard together with this case.

Respectfully submitted.

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MARCH 1995

No. 94-1292

# In the Supreme Court of the United States

OCTOBER TERM, 1994

BRUCE BABBITT, SECRETARY OF THE INTERIOR, ET AL., PETITIONERS

*v.*

PHILLIPS PETROLEUM COMPANY, ET AL.

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## REPLY BRIEF FOR THE PETITIONERS

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## TABLE OF AUTHORITIES


| Case: | Page |
|---|---|
| *Shalala* v. *Guernsey Memorial Hospital*, 115 S. Ct. 1232 (1995) | 6, 7, 8 |
| **Statutes and regulations:** | |
| Administrative Procedure Act, 5 U.S.C. 551 *et seq.*: | |
| 5 U.S.C. 553 | 1 |
| 5 U.S.C. 553(b)(A) | 6 |
| Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. 1721(a) | 3 |
| 30 C.F.R.: | |
| Section 206.150 (1987) | 3, 7 |
| Section 218.54 | 3 |

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## REPLY BRIEF FOR THE PETITIONERS

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Respondents do not dispute the existence of a conflict among the courts of appeals over the use of the "substantial impact" test to determine whether an agency action requires notice-and-comment rulemaking under the Administrative Procedure Act (APA), 5 U.S.C. 553—a question on which this Court has previously granted review (see Pet. 14-15). They do not contest that the court below relied on the "substantial impact" test in requiring notice and comment for a "rule" that otherwise appeared to the court to fall "squarely within" an APA exemption.

Pet. App. 9a. And they do not defend the "substantial impact" test on its merits.

Respondents instead devote the bulk of their submissions to arguments based on inaccurate assertions about the nature and operation of the internal Minerals Management Service (MMS) "Procedure Paper" at issue in this case. Respondents contend, for example, that the paper "imposes substantive obligations" (ARCO Br. in Opp. 22), "forecloses alternative valuation methods" (*id.* at 23), and "forbids consideration of posted prices or the other factors enumerated in the [published valuation] regulation" (Phillips Br. in Opp. 11). See also, *e.g.*, Phillips Br. in Opp. 6-7, 9-10; ARCO Br. in Opp. 19. Respondents' arguments that the procedure paper is a "substantive rule" under "any reasonable analysis" (Phillips Br. in Opp. 10; see ARCO Br. in Opp. 19, 21-22) depend entirely on their misapprehension of the paper's purpose and effect. And those arguments do not, in any event, detract from the need for this Court's review to resolve not only the circuit conflict over the "substantial impact" test, but also broad and recurring questions concerning the scope of the three APA notice-and-comment exemptions that the court of appeals held inapplicable to this case.

1. As our petition explains (at 6-8, 14-22), the procedure paper is, in and of itself, no more than an internal enforcement policy memorandum prepared by agency compliance personnel for their own guidance in auditing the values used by lessees to calculate the royalties owed on particular by-products of their natural gas production. After the procedure paper was circulated within MMS, an auditor's determination that values and royalties were underreported on a given lease remained subject

to appeal by the lessee to the Director of MMS, and thereafter to the Interior Board of Land Appeals (IBLA). In any such appeal, the question remained whether MMS officials had reasonably determined that royalties had been underpaid. The governing legal standard remained that of the then-applicable regulation, 30 C.F.R. 206.150 (1987) (value for royalty purposes must "never be less than the fair market value"), and the final agency decisionmaker remained free to modify or reject determinations made at earlier stages in the administrative process.[1]

As the IBLA made clear in its decision on ARCO's administrative appeal of one of the orders at issue in this case, the procedure paper "did not require lessees to value their production by any specific method, nor did it modify any existing regulation." Pet. App. 117a. Indeed, in that case the IBLA—the only body authorized to speak for the Secretary on valuation matters contested by a lessee (see Pet. 16 n.4)—rejected a significant aspect of the procedure paper's "yardstick" methodology and remanded for a recomputation favorable to ARCO. Pet. App. 119a-120a; see Pet. 9-10, 16. And in other cases the Board has upheld the use of non-"yardstick" valuation methods for natural gas liquid products (NGLPs) in

[1] Respondent Phillips complains (Br. in Opp. 3) that the prospect of late payment charges on underpaid royalties puts it at "significant financial risk of misgauging the government's later assessment of the reasonable value of production." Any late payment charges that may be imposed, however, amount to no more than interest on the amount determined to have been underpaid. Those interest charges are required by 30 U.S.C. 1721(a), and reflect only a suitable measure of the value to the lessee (and the cost to the United States) of the delay in payment. See 30 C.F.R. 218.54.

appropriate circumstances. See Pet. 20-21 & n.6. The characterization of the procedure paper around which respondents have constructed their briefs in opposition is therefore simply inaccurate.

ARCO points out that a similar view of the procedure paper informed the court of appeals' determination—under the "substantial impact" test that we challenge—that notice-and-comment procedures were required in this case. Br. in Opp. 18-19, citing Pet. App. 10a-11a. ARCO cannot shield the court of appeals' error from review, however, by terming it a "factual finding" (Br. in Opp. 20). If the question of the procedure paper's proper place in the administrative scheme were a "factual" one, it would have been settled by the conclusions of the IBLA (Pet. App. 117a-118a) and the district court (*id.* at 62a-63a) that the paper "is interpretive in substance and application, and, * * * itself, is not the source of any substantial impact." *Id.* at 63a. But the question whether a particular agency document is a "rule" that must be promulgated in accordance with the notice-and-comment procedures of the APA is one of law, not of fact. Any subsidiary questions about the purpose and application of the procedure paper are readily answerable on the record in this case (particularly given the deference owed an agency's explication and application of its own materials and processes), and there is no impediment to this Court's correction of the court of appeals' legal error.

2. At various points ARCO defends its characterization of the procedure paper as a "final agency requirement," imposing substantive obligations, on the ground that one of the five NGLP valuation orders at issue here was reviewed and upheld (in part) by the IBLA (and the government thereafter did not

challenge the finality of the remaining orders for purposes of this litigation). Br. in Opp. 10, 15-17 & n.13. ARCO cannot disguise the nature of the procedure paper itself, however, by pointing out that particular administrative orders that rely, in whole or in part, on the paper's suggested valuation methodology in resolving individual valuation disputes become binding once the IBLA acts (or if the lessee fails to seek IBLA review within the time allowed).

After the IBLA ruled on the one administrative appeal taken by ARCO, it may be that subsequent appeals to the Board on substantially identical facts were not likely to produce a decision in ARCO's favor. See ARCO Br. in Opp. 17. That result, however, would be attributable to the precedential effect of the IBLA's prior decision adopting a modified version of the methodology contained in the procedure paper, rather than to any binding force of the paper itself. In this respect, the effect is the same as if MMS had urged the valuation methodology in a brief to the IBLA, and the IBLA had adopted those parts that the Board found persuasive. The fact that MMS wrote its views down for itself before writing them down for the Board cannot make the difference between a permissible adjudication and an impermissible clandestine "rulemaking."

The court of appeals did not invalidate the orders at issue here because of any question about the legal or factual propriety of the valuation decisions reached by MMS or the IBLA with respect to the particular leases and periods at issue in the orders themselves.[2] Rather, the court accepted respon-

[2] Respondents effectively concede that the valuation methodology adopted by MMS was substantively reasonable.

dents' facial challenge to MMS's ability to issue *any* royalty compliance order, even at the initial stage of the administrative enforcement process, based on the valuation methodology set out in the procedure paper, unless and until that methodology was adopted through notice-and-comment rule-making. That challenge, and the decision below, must stand or fall based on the proper application of the APA to the procedure paper. And that is the question presented by our petition. Pet. i.

3. Respondent Phillips cites this Court's recent decision in *Shalala* v. *Guernsey Memorial Hospital*, 115 S. Ct. 1232 (1995), for the proposition that an agency must undertake notice-and-comment rule-making whenever it "adopt[s] a new position inconsistent with * * * existing regulations." Phillips Br. in Opp. 10 (quoting *Guernsey Memorial Hospital*, 115 S. Ct. at 1239). Phillips maintains that the procedure paper cannot fall within the APA's exception for "interpretative rules," 5 U.S.C. 553(b)(A), because the paper "did not even acknowledge the existence" of the governing regulation, and in fact proceeded "in direct contravention of the [regulation's] express terms." Br. in Opp. 11. As we have pointed out (Pet. 18-19 & n.5), however, the paper in fact begins by identifying a practical valuation problem and stating the generally applicable regulatory standard, and it then sets out an admin-

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See ARCO Br. in Opp. 6 (there is "no reason why ARCO could not, and would not, have used the [prices] specified in the Procedure Paper" had it known of the paper); Phillips Br. in Opp. 11 (agency "was free to make the substantive judgment that 'spot prices * * * are a better indicator of value than posted prices'" (quoting Pet. App. 106a)).

istrative view about how the identified issue should be resolved under several variations of a specific factual scenario. See Pet. App. 130a. And rather than ignoring or "forbid[ding] consideration" (Phillips Br. in Opp. 11) of the factors listed in the regulation, the paper specifically considers all of them—or, in the case of "posted prices," the best analogue available under the particular circumstances involved. See Pet. 19 n.5.[3]

Indeed, on any proper understanding of the origins and functions of the procedure paper, *Guernsey Memorial Hospital* can only support the government's position in this case. The provision of the Medicare Provider Reimbursement Manual (PRM) at issue in *Guernsey Memorial Hospital* was actively provided to relevant members of the public, and was at least to some extent authoritative as a public expression of the view of relevant agency officials concerning the proper application of the Medicare Act and the agency's general regulations to a particular cost reimbursement situation. See 115 S. Ct. at 1234, 1239. The procedure paper at issue here, by contrast, is an internal, non-binding statement of general enforcement policy, developed by and for front-line agency compliance personnel for use in the initial stages of what is essentially a system of case-by-case adjudication. Even if such a document may properly

[3] In their extensive reliance on the governing regulation, respondents studiously ignore its injunction to consider "other relevant matters," 30 C.F.R. 206.150 (1987)—a category that would certainly include the spot prices that the paper's authors determined (Pet. App. 132a) generally "represent[ed] the best available price source" in the special context of NGLPs used internally by a lessee or disposed of in non-arm's-length transactions. Compare, *e.g.*, Phillips Br. in Opp. 11-12.

be characterized as a "rule" at all, see Pet. 15-17, it surely cannot be *less* of an "informal * * * guideline" than the provision that the *Guernsey Memorial Hospital* Court characterized as a "prototypical example" of the sort of "interpretive rule" that is *not* subject to notice-and-comment rulemaking under the APA. *Guernsey Memorial Hospital*, 115 S. Ct. at 1234, 1239.

As the dissent in *Guernsey Memorial Hospital* recognized, a government agency

> certainly cannot foresee every factual scenario with which it may be presented in administering its programs; to fill in the gaps, it must rely on adjudication of particular cases and other forms of agency action, such as the promulgation of interpretive rules and policy statements, that give effect to the statutory principles and the background methods embodied in the regulations.

115 S. Ct. at 1243-1244 (O'Connor, J., dissenting). The MMS "procedure paper" at issue in this case did, at most, no more than that. Every federal agency that has compliance and enforcement responsibilities must have the ability to undertake internal consultation and coordination of the sort embodied in the MMS paper, and to issue and defend orders based on theories so developed, without submitting every written product of those internal processes for public notice and comment. Respondents offer no persuasive answer to our explanation (Pet. 26-28) of why the court of appeals' decision to the contrary not only conflicts with decisions of other courts of appeals, but also poses a serious threat to the orderly and efficient conduct of the government's administrative business.

* * * * *

For the foregoing reasons and those set forth in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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*Solicitor General*

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